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MESSAGE FROM THE PATRON

At the outset, I would like to recognize the immense effort undertaken by the student body of the Centre for Business and Commercial Laws, under the guidance and tutelage of the Chairperson of CBCL, Prof. (Dr.) Ghayur Alam, in successfully completing the third volume of the Journal of Business Laws. The team's effort is reflected in the fact that this edition was conceived and compiled, despite the challenges of a global pandemic, with everyone transitioning to the online world with grace and resilience.

The Journal's aim mirrors CBCL's enduring resolve encourage academic writing in the field of corporate and commercial laws. The diverse form of academic writings that constitute the Journal ensure that it is able to chart the vast expanse of the field of business and commercial, giving a bird's eye view of the field to the reader while explaining the intricacies that underpin this area of law. Consequently, the publication of this Journal of Business Laws is a small, yet meaningful academic contribution for the legal fraternity in India and abroad.

In this edition of the Journal, one can see a wide range of commercial matters being addressed. Ranging from the impact of the COVID-19 outbreak on debt capital markets, and usage of the IBC as a debt recovery tool, to the evolving role of a Resolution Professional, and taxability under the GST model, diverse and riveting issues of contemporary commerce and corporate themes have been critically analyzed and presented by distinguished researchers. I would like to thank them for their contribution to this publication and motivate them to pursue and contribute to this significant area of trade and business.

A thriving culture of students' activities and participation is intrinsic to the success and prosperity of any educational institution. With this publication of NLIU Journal of Business Laws, the students of NLIU have contributed immensely to the public perception of NLIU among the legal fraternity. I wish to extend my deep appreciation for the sincerity and diligence with which the team of CBCL has undertaken the task of publishing this commendable journal, and congratulate Prof. (Dr.) Ghayur Alam to whom the students turned for guidance and support. I am confident that this journal would earn repute and recognition from the legal fraternity and continue to flourish in the years to come.

PROF. (DR.) V. VIJAYAKUMAR

VICE-CHANCELLOR

NATIONAL LAW INSTITUTE UNIVERSITY, BHOPAL

ANALYSIS THROUGH AGENCY – THE DOCTRINE OF UNDISCLOSED PRINCIPAL AND THE CORPORATE VEIL

Soumya Ghosal[1]

ABSTRACT

Ordinarily, the law of agency dictates that an agent cannot be made liable for the actions they have undertaken on behalf of the principal. However, if the agent, as part of the understanding with the principal, does not disclose their name to the person they are dealing with, the agent can be made personally liable for his actions. This is the Doctrine of Undisclosed Principal. Both undisclosed principal and corporate veil doctrine have evolved to ease the conduct of business. But can the former be used to supplement the latter? This paper explores whether a shareholder's liability can be viewed through the lens of agency and doctrine of undisclosed principal and why such an interplay may be relevant?

I. INTRODUCTION

One of the major ways the Company structure of a business corporation is beneficial is the treatment of a Company as a separate and independent legal entity, detached from its shareholders, thereby

[1] The author is a 4th year student of West Bengal National University of Juridical Sciences, Kolkata (WBNUJS).

bestowing only limited liability upon them.[2] Thus, while creditors to whom the company owes debts may reach for the assets in the name of the company, they cannot reach for the members' personal property.[3] These creditors may pray to the Courts to *pierce the corporate veil* – which means - to treat the actions of the company as the actions of the individual members.[4] While the Courts usually try to protect the separate identity of the company, they may be inclined to look behind the corporate veil- "when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons."[5] However, such extreme action is not always desirable and the Courts may want to opt for an option within the jurisprudence of agency law which balances the interests of the petitioners as well as protect the corporate veil.

Accordingly, in the laws relating to contracts and agency, the Doctrine of undisclosed principal alludes to the liability of an agent under special circumstances.[6] Ordinarily, an agent cannot be made liable for the actions they have undertaken on behalf of the principal.[7] However, if the agent, as part of the understanding with the principal, does not

[2] Aaron Larson, 'Piercing the Corporate Veil', October 5, 2015, available at: https://www.expertlaw.com/library/business/corporate_veil.html, accessed November 3, 2021.
[3] I*d*.
[4] *Id*.
[5] US v. Milwaukee Refrigerator Transit Co. 142 Fed. 242,247, J Sanborn.
[6] Draper Lewis, 'The Liability of the Undisclosed Principal in Contract', (1909) 9(2) Columbia Law Review 116.
[7] *Id*.

disclose their name to the person they are dealing with, the agent can be made personally liable for his actions.[8]

Both the principle of corporate veil and the doctrine of undisclosed principal are products of Common Law jurisprudence, having been encapsulated within various jurisdictions either through statutory enactments or judicial pronouncements.[9] While these concepts are enshrouded in levels of ambiguity, given that they both operate in similar realms of commercial transactions, the interplay between them is inevitable.[10] In this paper, it is this interplay that we focus on.

II. DOCTRINE OF UNDISCLOSED PRINCIPAL

The doctrine, while in existence since the early 20th Century Privy Council case of *Keighley, Maxsted & Co v Durant*,[11] has been most importantly explained in the case of *Siu Yin Kwan* v. Eastern Insurance Co Ltd (hereinafter "*Siu Yin Kwan*").[12] The judgment defined important elements regarding an undisclosed principal in a contract,[13] and more significantly, recognized that though it is an important and accepted part of common law because it creates ease of business, the doctrine runs *per contra* to the very fundamental principle of privity

[8] I*d.*
[9] Deeksha Bhana, 'Should the Doctrines of the Undiclosed Principal or Piercing the Corporate Veil Determine the Locus Standi of a Party to Sue in Terms of a Contract? - The Conundrum of Botha v. Giyose t/a Paragon Fisheries', (2010) 127(1) South African Law Journal 5.
[10] *Id.*
[11] Keighley, Maxsted & Co v. Durant [1901] AC 240.
[12] Siu Yin Kwan v Eastern Insurance Co Ltd [1994] AC 199.
[13] *Id.*, 207E.

of contract.[14] The position in *Siu Ying Kwan* has been applied by the House of Lords in subsequent cases,[15] and has also found application in other jurisdictions.[16]

The Doctrine of Undisclosed principal, as it stands today, provides for two thresholds which ought to be met by the agent to avoid liability – they must make it abundantly clear that they are only acting in the capacity of an agent and, more importantly, they must disclose the identity of the real Principal.[17] The question as to whether these disclosures have been adequately made to the purchaser is to be determined upon the analysis of the individual case.[18] When the Court concludes that such disclosure has not been sufficiently made to the contracting party, the latter is well within their right to sue the Agent personally for any breach or losses incurred due to the agent's actions.[19]

III. SEPARATE ENTITY DOCTRINE AND THE CORPORATE VEIL

In *Saloman*, the main question that the House of Lords needed to answer was the question of the company's autonomous identity.[20] The facts of the matter were thus: Saloman, and the members of his family

[14] I*d*., 207F.
[15] Boyter v Thomson [1995] UKHL 15, [1995] 2 AC 628.
[16] Tey v Optima Financial Group Pty Ltd [2010] WASCA 219 [Australia].
[17] John Geyer, 'Let the Agent Beware: Wilkinson v Sweeny and the Undisclosed Corporate Status', (1990) 50(6) Louisiana Law Review 1183, 1185.
[18] *Id.*
[19] *Id.*
[20] Saloman v. Saloman, [1897] AC 22.

held together all of the seven shares in the company.[21] Upon securing a substantial number of the shares and appointing himself as the Managing Director, Saloman secured a hefty amount from a number of creditors.[22] When the company failed, the liquidator claimed that the Company was really an agent of Saloman and thus he could be made personally liable.[23] Saloman rejected such contention, claiming the transactions were done by the company and he could not be held personally liable for the same.[24]

The House of Lords enquired into the matter and found that the company was legally formed and registered and thus it had a **separate identity** of its own and could not be merely seen as the agent of its shareholders.[25] While the concept of a separate personality of a company had been previously acknowledged by a Bench in *R v. Arnaud*,[26] *Saloman* clarified the position for once and all – the identity of a company is distinct from its shareholders and, ordinarily, they cannot be held liable for the actions of the company.[27]

Tom Spencer writes that while *Saloman* purports the Separate Identity doctrine, that is, a corporate entity that is duly incorporated is one that exists independently of its members, but the same is distinct from the concept of a corporate veil.[28] The idea of corporate veil is a

[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Id.*
[25] Tom Spencer, 'Finding the Wisdom of Saloman', (2012) 40 Australian Business Law Review 64, 70.
[26] R v Arnaud (1846) 9 QB 806.
[27] Spencer n 22, 70.
[28] *Id.*,71.

presumption of the distinct identity of the company, and this presumption can be rebutted under certain circumstances.[29] The corporate veil may be lifted when a company, while remaining a separate entity, is shown to be acting as an agent for the actions of its members.[30]

It is thus proposed that there is a distinct lens through which the concept of corporate veil can be visualized – one which focuses on the Law of Agency, and more specifically, the doctrine of Undisclosed Principal.

IV. SHAREHOLDER'S LIABILITY THROUGH THE LENS OF AGENCY AND DOCTRINE OF UNDISCLOSED PRINCIPAL

A shareholder's liability with respect to the actions of a company is kept to a minimum.[31] This is in line with the Company retaining its Separate Identity, making such liability, if recognized, a matter of "rare exception".[32]

Robert Hamilton poses a different, "somewhat more meaningful" way of looking at the duties of the shareholders – to view the shareholders as principals.[33] If the Company is seen as the shareholder's agent under the presently accepted laws of agency in common law, the liability imposed on them will be that of a Master being held liable for

[29] *Id.*
[30] *Id.*
[31] Larson n 1.
[32] Radio KBUY, Inc. v. Lieurance, 390 S.W.2d 16.
[33] Robert Hamilton, 'Corporate Entity', (1971) 49(6) Texas Law Review 979.

the actions of his servant (the company).[34] Similarly, when the shareholder commits a wrong while undertaking actions on behalf of the company, outside the purview of authorization, he will be held tortuously liable for the act as a shareholder.[35] In the latter case, the company is the Principal and the shareholder its agent. The real consideration to assert the liability of the shareholder, however, Hamilton proposes, is whether to see if the claimant in question *intended* to deal with the Corporation or whether they were under the impression that they are dealing with the shareholder personally.[36] In the case of the former, the creditor more or less assumed the risks involved, and unless fraud or other foul play could be shown, personal liability should not be imposed on the shareholder.[37]

Simply put, when the shareholder acts on behalf of the company, but the purchaser is unaware of the same, *the company becomes an undisclosed principal.* Thus, following the rules regarding the doctrine of Undisclosed Principal, the Agent, that is the shareholder, *must be held personally liable* for his actions.

On a similar line of logic, Spencer argues that the judgment in *Saloman* was not taken to its logical conclusion because it didn't account for the agency that wasn't of the shareholders.[38] He submits that "The Lord Chancellor did not address counsel's further argument, that the company was an agent of Salomon *as a managing director*. He simply held the company was independent for all purposes: 'Either

[34] *Id.*, 983.
[35] *Id.*
[36] *Id.*, 984.
[37] *Id.*
[38] Spencer n 22,71.

the limited company was a legal entity or it was not. If it was, the business belonged to it and not to Salomon. If it was not, there was no person and nothing to be an agent at all; and it is impossible to say at the same time that there is a company and there is not. If the company existed at all as a separate entity, it was independent of Salomon *for all purposes*" (emphasis provided).[39] Spencer proposes that it was absolutely possible for the House of Lords to hold that the company was independent of Saloman the shareholder, but *was an agent* of Saloman the Managing Director, because the company lacked a board of directors, hence Saloman's decisions *were* the Company's decisions.[40]

Additionally, Spencer highlights that the doctrine of Undisclosed Principal was never argued in *Saloman.*[41] The doctrine could have been applied to the factual matrix to distinguish the authority of the company to behave like an agent for Saloman the Director, while continuing its separate identity as an artificial person which safeguarded Saloman the shareholder.[42]

V. RELEVANT CASE LAWS

In this section of the paper, we discuss a few important cases which have been decided across different jurisdictions, which either allude

[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.*

to or focus on the interplay between the Doctrine of Undisclosed Principal and Corporate veil jurisprudence.

A. SWEENY V. WILKINSON

In this case, S, a shareholder, and president of a company entered into a contract with W for a lease of an office.[43] S claimed later that he had disclosed his corporate nature to W during the negotiation.[44] However, nothing in the contract itself had any reference to the same and W sued S individually upon failure of payment.[45] S defended his case saying that the corporation alone should be held liable.

The Trial Court accepted S's argument, but the same was reversed by the Court of Appeal.[46] It stated that S had an *affirmative duty* to disclose the corporate status to W and upon failing to do so, he will be treated as the agent of an undisclosed principal (the company) and be made personally liable.[47]

B. ANDERSON V. SMITH

In this case, Hal Anderson entered into a contract with an architect, wherein the latter would provide for necessary work for a house he was building.[48] The contract was signed between the building's owner and the architect, soon after which Anderson executed the same in the

[43] Sweeny v Wilkinson, 532 So. 2d 243 (La. App. 3d Cir.).
[44] Geyer n 29, 1185.
[45] *Id.*
[46] *Id.*
[47] *Id.*
[48] Anderson v Smith, 398 SW 2d 759 (Tex.Ct. App. 1965).

same of the company owned by him – Hal Anderson, Inc. The architect named the necessary bills under "Hal Anderson" and would receive cheques drawn on “Hal Anderson, Inc.”.[49] The architect later alleged that this discrepancy was never noticed by him and he was unaware that he is working for a company and not the person.[50] Upon completion of the work, the company failed to make the final payments.[51] The architect brought a suit against Hal Anderson personally, who defended himself on the ground that he was merely acting as an agent for his corporation.[52]

The Circuit Court in its judgment saw no need to pierce the corporate veil in this case.[53] The Bench concluded that even if it were to be held that Hal was acting only as an agent of the corporation, since the existence of the company was undisclosed to the architect, as the agent of an undisclosed principal, Hal would be held personally liable.[54] The defense argued that the architect had all the means to find out the true nature of the transacting party, to which the Bench responded that for the application of undisclosed principal “knowledge of the real principal is the test, and this means actual knowledge, not suspicion.”[55] Thus, the onus to disclose the nature of the corporate status was on the Agent (Anderson) and upon the failure to do so, he is personally liable to the architect.[56]

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[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] Hamilton n 29, 984.
[54] *Id.*
[55] Anderson v Smith, 398 SW 2d 759 (Tex.Ct. App. 1965).
[56] Hamilton n 29, 1193.

C. BOTHA V. GIYOSE TIA PARAGON FISHERIES

The appellant in the case, Mr. B, got into a contract for fast food with Mr. G.[57] As per the terms of the same, B sold his enterprise to G for a certain amount, half of which was paid in cash immediately while the rest was to be paid in installments over 24 months, with an interest of 5%PA. Eventually, G would fail to make the payments.[58] B sues for specific performance and receives a favorable judgment.[59] During the trial, it was disclosed that the products sold did not belong to B personally, but to company D, of which B was a member.[60] In light of this G files an appeal to the Eastern Cape High Court, arguing that B was only an agent of the company and had no locus to file the suit.[61]

The High Court treated D as the undisclosed principal and B as his agent and held that insofar B acted on behalf of D, he would be considered an agent of D.[62] However, the High Court held that since B had sought to file the suit in his personal capacity, he did not have locus standi. B appeals the judgment to the South African Supreme Court.[63]

The Supreme Court overruled the High Court's decision based on the terms of the contract. The bench, however, observed that at all times in his transactions with G, B had acted in his personal capacity.[64] B

[57] Botha v Giyose t/a Paragon Fisheries [2007] SCA 73 (RSA).
[58] *Id.*
[59] Bhana *supra* note 8, p.9.
[60] *Id.*
[61] I*d.*
[62] *Id.*
[63] *Id.*
[64] *Id.*, 10.

made no reference to D, either as his principal or otherwise as the owner of the products he was selling. Rather, B treated the products as if they were his own, there being no distinction between himself and D.[65] The Court held the ratification from the Undisclosed principal *cannot be post-facto*. Thus, B lacked authority to act on behalf of D.[66] Unfortunately, the Supreme Court does not satisfactorily articulate why it rejects the finding of the High Court vis-à-vis why the doctrine would not apply.[67]

Deeksha Bhana notes that in *Botha*, the Court does elude to piercing D's corporate veil, albeit quite cryptically, and it is very unclear as to how they viewed the interplay of the two doctrines.[68] Bhana, unlike Spencer and Hamilton, sees this interplay as one that would be undesirable.[69] She writes, "Whereas the function of the doctrine of veil piercing is to cast away the separation and deal with the corporation's assets and liabilities as if they were those of the member personally (and vice versa), the doctrine of the undisclosed principal's contemplation of a substitution of parties in the 'interests of justice' operates on the premise of the parties being distinct legal persons, where one party is mandated to act for the other. Thus, if on the one hand, the doctrine of veil piercing was applicable, it would support the position that B had been the owner of the business that he personally sold to G. On the other hand, if the doctrine of the undisclosed principal were applicable, it would support a finding of B having acted as an undisclosed agent for D in concluding the contract of sale with

[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] *Id.*, p.17.
[69] *Id.*

G. In the final event, it would appear that the doctrine of piercing of the corporate veil would provide the better fit in relation to the factual issue of B's lack of title to the products, however, conflating the two would only further obscure the Court's reasoning."[70]

VI. WHY DOES THE INTERPLAY MATTER?

One of the major reasons the interplay of Doctrine of Undisclosed Principal and Piercing of Corporate veil is so relevant is rooted in the idea of **Equity**.[71] Laws regarding contracts have always had an element of equity to them – to protect the party who might not have the same bargaining power as the other.[72] Starting from *Saloman*, Courts have usually been reluctant to pierce the corporate veil. There is an incentive in preserving the Separate identity of the company as it offers protection that facilitates ease of business.[73] When a Court is faced with a situation when the actions of a shareholder have *prima facie* disadvantaged another party for their own advantage, through fraud or other ways, it may be inclined to pierce the corporate veil. This can be circumvented, instead shifting the loss to the actions of the individual shareholder, *acting as an agent*, to the Undisclosed Principal (the company).[74] To illustrate the same, we look at the

[70] *Id.*
[71] Geyer, n 29, 1185.
[72] *See* Sudip Ranjan et al, 'Contract as Equitable Instrument - Sensibility in Indian Contract Act', May 2011, available at: https://www.researchgate.net/publication/228226450_Contract_as_Equitable_Instrument_-_Sensibility_in_Indian_Contract_Act#:~:text=Equity%20is%20aimed%20at%20preventing,have%20allowed%20to%20do%20so accessed July 11, 2022.
[73] Larson n 1.
[74] Geyer n 29, 1185.

instances of the relevant case laws mentioned above. In *Sweeney*, had the Court not decided to hold the shareholder personally liable, it would be grossly unjust to the duped party. Similarly in *Anderson*, the Court decides to hold the shareholder liable, despite the fact that the architect had the means to find out the true nature of the transaction. This is because it is in the interest of justice that a person attempting to deceive another party isn't allowed to go unpunished based on mere technicalities of the law. While the correctness of this approach can be questioned, it allows the Court to protect the rights of the consumer who have been duped, who often cannot compete against wealthy corporations, while also not disturbing the legal fiction of the corporate veil and the ease of their business.[75]

VII. CONCLUSION

The Doctrines of Undisclosed principal and the corporate veil are ever so significant because they focus on the most important aspect of commercial law – the ease of business. However, piercing of corporate veil may be necessary for the protection of the less powerful in the transaction. Through this paper, the author has proposed to look at the concepts of the need of piercing of the veil through the lens of agency, especially vis-à-vis undisclosed principal. It is also submitted that applying the doctrine of undisclosed principal in situations when the shareholders or director dupes the transacting party could help protect the rights of the less powerful while also not disturbing the ever-important ease of business.

[75] *Id.*

ANALYSIS OF 'SOCIAL' IN THE ESG REPORTING OF VOLUNTARY AND MANDATORY REGIMES DURING THE PANDEMIC

Devanshi Gupta and Shubham Prakash Mishra[76]

ABSTRACT

This paper attempts to establish the effects caused due to covid-19 on ESG (Environmental, Social and Governance) investments in the corporate market. Although Environment and Governance part in ESGs are profoundly discussed in the mainstream, the social element becomes more critical during the Pandemic. This paper further substantiates its claim by examining ESG investments with a particular focus on the social factor. Corporate Social Responsibility 'CSR' acts as a powerful tool to boost social factors, especially in the mandatory regime. Indian corporates are restricted by this mandatory approach taken by the legislature in effectively utilising their CSR funds and activities for Pandemic related action plans. Therefore, the authors attempt to do a comparative analysis of the mandatory regimes to voluntary ones and try to devise strategies that the mandatory regimes should follow to effectively mitigate the Pandemic and boost the social factor of ESG for investments. Within the Indian context, this was crucial to further re-imagine the concept of CSR and appreciate the fluidity from international standpoints. Regardless, this paper will also critically examine the administrative and executive obstacles in implementing international standards within the Indian regime. This paper concludes that strengthening the social element in

[76] The authors are fifth year law students at Jindal Global Law School.

ESG acts as a symbiotic process amongst multiple stakeholders with fruitful investments for the Indian companies in return.

I. OVERVIEW AND UPTREND OF ESGs IN THE PANDEMIC

The crash landing of the novel coronavirus "Covid-19' or 'Pandemic' led to the disruption and introduction of numerous bottleneck problems in different fields across the globe. It forced a global shutdown and standstill as many countries underwent stringent lockdown or curfews to prevent the spread of the disease. This resulted in a mass spread of chaos and the consequent introduction of a deep-rooted socially and economically systemic crisis.[77] The world saw a negative financial impact on economies due to decreased productivity, lack of human resources in companies, and the shutdown of industries. Due to the lack of experience, most corporate entities, both domestically and internationally, have not appropriately allocated funds or taken adequate preventive and preparedness measures to mitigate the dangers of massive epidemics and systemic financial crises.[78] Struggling to cope now, the outbreak is acting like a global "wake-up" call to reinforce cooperation, make sustainable investments as a preparedness method for epidemic disasters and offer the necessary funds worldwide for collective action. The effects can be seen when it was recorded that more than 70% of the asset owners

[77] EPW Engage ‘COVID-19: Examining the Impact of Lockdown in India after One Year’, available at: https://www.epw.in/node/158248/pdf accessed 23 August 2021.
[78] ET Bureau, ‘Lockdown is hurting and can get worse’ The Economic Times, available at: https://economictimes.indiatimes.com/news/economy/lockdown-is-hurting-and-it-can-get-worse/huge-economic-costs/slideshow/75344561.cms accessed 24 August 2021.

have incorporated huge investments into ESG strategies. A major ideological shift was seen amongst investors who urged business enterprises to prioritise the worker's social life, good health and well-being, while the lockdown induced environmental conservation by decreasing carbon emissions, suggesting the prioritisation of environmental policies. Lastly, the governance structure of companies was scrutinised extensively for their corporate social and economic responsibility.

According to International Monetary Fund, in its latest report on global financial stability, it was seen that the financial system had faced unprecedented consequences, and the further deterioration of the crisis may affect the global financial ground.[79] These consequences triggered a novel thinking on investments strategies, before the COVID-19 crisis, the level and trend of internal and external funding had discrepancies and long-term effects; the company's corporate social responsibility was a lingering factor. However, in the global context, an economic trait that attracted a positive bent is the ESG investments by the business houses. As Financial Times defines, ESG investment is a generic term used in capital markets and used by investors to evaluate corporate behaviour and determine future financial performance.[80] Investors use it to evaluate corporations and determine the future financial performance of companies through their investments in environmental, social, and governance factors. A report by the Organisation for Economic Co-

[79] IMF Blog, 'COVID-19 Crisis Poses Threat to Financial Stability, available at: https://blogs.imf.org/2020/04/14/covid-19-crisis-poses-threat-to-financial-stability/ accessed 23 August 2021.
[80] ADEC Innovations 'What Is ESG Investing?', available at: https://www.esg.adec-innovations.com/about-us/faqs/what-is-esg-investing/ accessed 23 August 2021.

operation and Development Committee on Financial Markets broader body of work to monitor developments in ESG rating and investing OECD, stated that sustainable financing is seen to be proliferating in recent years, as the institutional investors and funds incorporate various ESG investing approaches.[81] This report provides an overview of concepts, assessments and conducts quantitative analysis to shed light on both the progress and challenges concerning the current state of ESG investing. It sheds light on various metrics and approaches that formed an essential guide for ESG investments worldwide.

Financial Performance Evaluation measures a company's financial health that determines the practical usage of company resources in generating sustainable revenues and operating income. In contrast, non-financial performance measurement is a measure for establishing non-financial indicators of a business, which focuses on the long-term success and the qualitative aspects of a business. Both the financial prospects faced a downturn due to the covid-19 Pandemic, and this element proved to be a significant turning point for ESG investment. It is created a milestone on corporate house's involvement in more sustainable investments. As ESG technically evaluates the company's far-fetched financial and non-financial performances, the investments made by the companies into their business under the angles of environment, social, and governance of the business was prioritised to ensure corporate social responsibility.[82]

[81] OECD Publishing, Paris, 'OECD Business and Finance Outlook 2020: Sustainable and Resilient Finance', available at: https://www.oecd.org/daf/Sustainable-and-Resilient-Finance.pdf accessed 23 August 2021.
[82] *EPW Engage* (n 2).

A survey study conducted by the Harvard Law School[83] on "ESG investing, pre and post-pandemic" revealed that there was a considerable escalation in ESG investments, more particularly the social and governance factor in ESG showed tremendous growth. This investment strategy by the business house considers the possible environmental, social, and governance risks manifested, which have an indefinite impact in the market, and investment for mitigation and protection was considered imminent.

The paper aims not to explore the existing literature on mandatory versus voluntary discourse but to analyse it in light of strengthening the social factor of ESG in the COVID Pandemic. Therefore, the primary tool to strengthen this social factor will be CSR enforcement strategies while performing a comparative analysis of regimes

II. THE IMPORTANCE OF 'S' ELEMENT IN COVID

S&P's Global ESG Head, Manjit Jus, in his article, "The 'S' in ESG Gains Currency," states that the companies are making progress in disclosing their environmental impact and governance standards, but social factors have not been given the same attention, until the Pandemic.[84] However, The social element of ESG issues can be the

[83] Harvard Law School Forum on Corporate Governance, 'Survey Analysis: ESG Investing Pre- and Post-Pandemic', available at: https://corpgov.law.harvard.edu/2020/10/20/survey-analysis-esg-investing-pre-and-post-pandemic/ accessed 23 August 2021.

[84] Wolters Kluwer Enablon 'The 'S' in ESG and Social Factors Become More Important', available at: https://enablon.com/blog/the-s-in-esg-and-social-factors-become-more-important/ accessed 23 August 2021.

most difficult for investors to assess.[85] Unlike environmental and governance issues, which are more easily defined, have an established track record of market data, and are often accompanied by robust regulation, social issues are less tangible, with less mature data to show how they can impact a company's performance.[86]

ESG investments post covid placed greater weight on the 'social' domain of ESG; it boosted workplace safety, treatment of employees, retail investments to employees' health and safety, diversity and inclusion, and supply chain. With the high chances of getting affected by epidemic stressors, the post-covid phase prioritises worker's health and well-being.[87] Furthermore, the companies started to incline more towards corporate social responsibility strategies; they started prioritising shareholders proposals with ESG engagements with primary growth drivers, clientele safety, racial inequality and diversity, and more regulatory changes.

Along with business profit plans, post covid scenario catalysed the governance domain of ESG by making the governance structure of the companies more resilient and comprehensive towards social and economic stressors. Studies and surveys prove that the company's

[85] Principles for Responsible Investment, 'Esg Integration: How Are Social Issues Influencing Investment Decisions?', available at: https://www.unpri.org/download?ac=6529 accessed 23 August 2021.
[86] GreenBiz, 'The 'S' in ESG gains currency', available at: https://www.greenbiz.com/article/s-esg-gains-currency accessed 28 August 2021.
[87] JP Morgan Insights 'Why COVID-19 Could Prove to Be a Major Turning Point for ESG Investing', available at: https://www.jpmorgan.com/insights/research/covid-19-esg-investing accessed 22 August 2021.

governance structure is modified to be more suitable for ESG investments, monitoring, and implementation. For example, hiring new-staffs for the ESG investment wing, creating more risk-adjusted returns in business, funds for aligning investment strategies and organisational values.

A report made by MSCI's research-based indexes and analytics group on "Introduction to ESG investments has provided a clear-cut objective of ESG investors; as integration and growth in investment returns, reflecting the companies' values and bringing about positive impact in the world.[88] Moreover, the same impacts the financial returns at a higher rate as such investment is a key concept in the ESG investment market, which would probably lead to more comprehensive investment studies and better-informed investment decisions if the ESG issues are taken systematically.

A study at Catholic University in Milan also shows that social criteria are essential for risk management.[89] The study analysed more than 1,000 companies from countries all across the globe for over a period of 14 years. The results show that high social standards can reduce a company's systematic risk. Moreover, companies with high social standards appear to react more robustly to occurrences such as

[88] MCSI ESG Research, 'Introducing ESG Investing', available at: https://www.msci.com/documents/1296102/7943776/ESG+Investing+brochure.pdf/bcac11cb-872b-fe75-34b3-2eaca4526237 accessed 23 August 2021.

[89] DWS Group 'The "S" in ESG: hard to grasp but important for risk management, available at: https://www.dws.com/insights/investment-topics/the-social-component-of-ESG/ accessed 30 August 2021.

inflation or periods of economic weakness and other emergencies, like the COVID pandemic in the current scenario.

Investors are tracking the companies' responses and simultaneously taking a forward-looking approach to understand how the response to COVID-19 may indicate how a company might respond to other challenging environments.[90] This is rooted in the belief that today's company's actions can have long-lasting implications related to material, social factors, such as employee satisfaction, worker safety, and productivity. In the United States, at least, the year 2020 was the year of the Pandemic and a cry for more equality, racial and gender justice, and in general, more respect for one another. Therefore, ESG reporting post the pandemic would not ignore the social component and continue to focus on gender diversity, human rights, and equality issues.

One primary method to strengthen the social factor is to use the Corporate Social Responsibility activities towards sustenance ethically. This will act as a symbiotic process as the employees, and the consumers who benefit from CSR activity will contribute towards a strong S factor in the ESG reporting. This crisis has put companies under test for their commitment to ethical business conduct and CSR, and many have risen to the rescue, especially companies that directly deal with the manufacturing and processing of medical supplies. Thus, this Pandemic offers excellent opportunities for firms to engage in

[90] Goldman Sachs Market Update – Commentary, 'COVID-19 and the Rising Importance of the 'S' in ESG' Asset Management, available at: https://www.gsam.com/content/gsam/no/en/advisers/market-insights/gsam-connect/2020/COVID-19_and_the_Rising_Importance_of_the_S_in_ESG.html accessed 30 August 2021.

various CSR initiatives during the crisis and potentially catalyse a new era of CSR development in the long run.[91]

III. MANDATORY INDIAN REGIME'S RESPONSE TO THE PANDEMIC

As discussed in the previous section, the genesis of corporate social responsibility (CSR) and Environmental, Social & Governance (ESG) standards is the same, i.e., the adoption of practices and policies by corporations intended to influence the world positively. CSR was the forerunner to ESG. Without CSR, there would be no ESG.[92] This is why it is essential to look at CSR when analysing the impact of the 'social' component of ESG. Therefore, this section will emphasise the mandatory CSR regime of India as a central point.

CSR did not statutorily exist before the Companies Amendment Act, 2013. The section 135[93] of the Act now makes India the first country with a statutory mandate for CSR. The provision has to be read with Schedule VII of the Companies Act, which provides for the activities undertaken under the purview of CSR policies. The CSR activities are very rigid as compared to the voluntary regimes as the 2(1)(b) CSR Rules, 2021[94] prescribe certain activities which are not counted as

[91] Lloyd Harris and Hongwei He 'The impact of Covid-19 pandemic on corporate social responsibility and marketing philosophy'. PMC (2020) 116 J Bus Res. 176–182.
[92] RTH Law Asia, 'Understanding And Adopting ESG – An Overview Part I: The Evolution Of ESG From CSR' available at: https://www.rhtlawasia.com/wp-content/uploads/2021/03/ESG-Part-I-The-Evolution-of-ESG-from-CSR.pdf accessed 24 August 2021.
[93] The Companies (Amendment) Act 2013, s 135.
[94] Companies Amendment Rules, 2021, s 2 (1)(b); ('CSR Rules, 2021').

CSR activities like activities benefitting the employees. This limits the companies to divert CSR funds towards their employees facing an unprecedented set of problems in the Pandemic. For example, this non-inclusion of employees has affected the migrants who were part of a large corporation, and now we are forced to leave without any financial assistance. Flexibility not in just terms of corporate governance but utilising CSR funds is a big drawback of these mandatory regimes. This also acts as a barrier for different entities as they will prefer governance regimes that suit their own individual characteristics.[95] The rigid CSR rules take a step backwards in carving out exclusions from the net profit so calculated as one of the exclusions provides that the profits of a branch of an Indian company located outside India cannot be merged into the profits of the parent company to compute the two per cent contribution. This exclusion goes against the very mandate of Section 135 and is, to that extent, ultra vires.[96]

The CSR Rules limit these companies to benefit their employees; thus, in the Pandemic, it cannot help the employees who are indirectly affected by the Pandemic or run programs that are meant towards tackling the Pandemic for the employees.[97] Schedule VII was amended to include contributions to PM CARES as CSR and, the MCA has also allowed spending of CSR funds towards Covid-19,[98]

[95] CORE UK, 'Voluntary Vs Mandatory Corporate Governance: Towards An Optimal Regulatory Framework', available at: https://core.ac.uk/download/pdf/76622037.pdf accessed 25 August 2021.
[96] Amee Ishwarbhai Dave, 'Voluntary vs Mandatory CSR', (2017) 6 IJIRMF 4.
[97] The Companies (Corporate Social Responsibility Policy) Rules, 2014.
[98] Ministry of Corporate Affairs, Government of India, General Circular No. 10/2020, available at: https://www.mca.gov.in/Ministry/pdf/Covid_23032020.pdf accessed 26 August 2021.

but they still exist ambiguity and lacuna. The central government has clarified that employee vaccination spending may not classify as CSR.[99] It is so because any amount spent by a company on its employees, contractors, business associates or anyone directly or indirectly associated with it is something that will benefit the corporate, and it is prohibited under the CSR Rules. In yet another development, the government amended the CSR norms to include research and development (R&D) spending on new vaccines, drugs, medical devices related to COVID-19.[100] However, this is only applicable for FY 2020-2023 and mandatorily requires collaboration with specified public institutions, therefore disallowing companies to choose the best collaborators for the R&D of vaccines. In cases of Pandemic or emergencies, mandatory regimes like India have to wait for executive approvals with many caveats, which is a lengthy bureaucratic process before they can tackle an unprecedented situation. Therefore, restricting CSR activities will negatively reflect on the Social component of the ESG Reporting.

According to MCA FAQs,[101]

[99] Business Standard, 'Employee vaccination spending may not classify as CSR, says Centre', available at: https://www.business-standard.com/article/companies/employee-vaccination-spending-may-not-classify-as-csr-says-centre-121042200045_1.html#:~:text=The%20Centre%20is%20reluctant%20to,included%20in%20their%20vaccination%20drive accessed 31 August 2021.

[100] Invest India, 'The changing landscape of CSR in India during COVID-19', available at: https://www.investindia.gov.in/siru/changing-landscape-csr-india-during-covid-19 accessed 23 August 2021.

[101] Ministry of Corporate Affairs, Government of India, General Circular No. 15/2020, available at: http://www.mca.gov.in/Ministry/pdf/Notification_10042020.pdf .

- The contribution made to CM's relief Fund and State Relief Fund does not count as CSR expenditure. This is very problematic as India had a total of 718 districts, of which, approx. Sixteen per cent were aspirational districts as per NITI Aayog. Jharkhand, Bihar, Chhattisgarh, Madhya Pradesh and Uttar Pradesh account for more than 55 per cent of the aspirational districts' concentration across India, yet received only nine per cent of the total expenditure towards CSR.[102] If contribution towards CM relief fund is allowed, corporate giants can use their funds towards targeted states with poor covid infrastructure as above instead of donating it to the PM Cares Fund, which will later allocate to the state at its discretion.
- Payment of salary to employees and daily wages or contractual workers and labourers during lockdowns is not counted towards CSR activities. As discussed above, there were millions of displaced labours in the first wave of Covid, which has resulted in the downtrodden of many corporations.[103] Allowing CSR Funds for payment of salaries during lockdown will work positively towards risk assessment factors in the social component of ESG.

As the mandatory regimes leave less room for discretion for the companies to decide their CSR activities, they have to rely on government circulars and interpretation. According to a survey, even though the MCA has clarified that all funds spent on COVID-19 management would be treated as eligible CSR activity, these guidelines remain broad-based. While the government has also subsequently released notifications providing further clarity, over 20% of respondents felt that unambiguity clarity regarding the ambit

[102] *CORE UK* (n 20).
[103] Ranjan Ranjan, 'Impact of COVID-19 on Migrant Labourers of India and China' (2021); Sage 47 Publication4, 722.

of CSR remains a challenge while undertaking CSR activities during a crisis.[104] This gives rise to the need for streamlined information on activities that are permitted as well as timely clarifications.

Apart from the CSR provisions, several other factors can promote the social component of ESGs in a mandatory regime like India. According to section 166 (2) of the Companies Act 2013,[105] the director shall promote the company's objects for the benefit of its members as a whole and in the company's best interests, its employees, the shareholders and the community, and the protection of the environment. This section gives directors the responsibility to assess and work towards the social factor, which includes a wide array of things as mentioned above.

Although there are numerous limitations to a mandatory regime, it comes with several beneficial factors. Mandatory regimes mandate companies to include CSR in investment treaties with strict compliance. States have, in more recent history, adopted the practice of including CSR provisions in their international investment agreements.[106] Indian regime, being a mandatory one, can pave the way by including CSR provisions that directly help tackle the Pandemic. Moreover, in mandatory regimes, compliance will be generally high if the penalties for the same are burdensome. In these regimes, the rate of compliance over time are both consistent and

[104] *CORE UK* (n 20).
[105] The Companies Act 2013, s 166 (2).
[106] ICAR, 'Corporate Social Responsibility Clauses In Investment Treaties: A Panacea Or A Plague?', available at: https://www.investmentandcommercialarbitrationreview.com/post/corporate-social-responsibility-clauses-in-investment-treaties-a-panacea-or-a-plague accessed 30 August 2021.

predictable. Therefore, compliance would not be an issue while undertaking pro-social steps that help in tackling Covid.

IV. VOLUNTARY REGIMES AND INTERNATIONAL STANDPOINT

Unlike the Indian regime, several other jurisdictions such as Canada, the UK and Australia follow the voluntary regime. A voluntary regime does not have a rigid compliance mechanism propagated through a legal structure, neither does it attach penalties to follow the same. There is no obligatory body that mandates following 'minimum standards' or practices whereas, they are only required to "disclose which practices they have and have not implemented and explain why (the "comply and explain" system)."[107]

The more considerable understanding is that voluntary regimes create a trend that invokes market responsibility; this becomes the 'cluster' effect and creates pro-CSR motivation amongst companies, given that the compliance is value-oriented and not purely law-oriented, in the case of tax.[108] An example of this can be seen in Australia, wherein despite there being a lack of legislative mandate, banks have been disclosing their CSR expenditure since 2010.[109] However, to ensure

[107] CORE UK, 'Voluntary Adoption of Corporate Governance Mechanisms: The Role of Domestic and International Governance Standards', available at: https://law.utexas.edu/wp-content/uploads/sites/25/anand_voluntary_adoption_corporate_governance_mechanisms.pdf accessed 23 August 2021.

[108] *Id.*

[109] National News 'In India, a legislative reform is needed to push corporate social responsibility', available at: https://nationalviews.com/india-legislative-reform-corporate-social-responsibility-csr accessed 2 September 2021.

that banks follow such good faith practices, Australia has set up several rules and guidelines that form a prudential regulation system, with checks and balances mechanisms to be complied with.[110] Additionally, in the United Kingdom, Boards' response to stakeholders needs and promoting ESG strategies and risk management has become more critical. An issue of 'anti-embarrassment' arises for companies that are not catching up with this growing trend, suggesting the formation of a self-regulated mechanism that ensures responsible behaviour while retaining corporate flexibility to choose their strategies.[111] Therefore, investors actively support social and ethical behaviour; additionally, being part of a voluntary regime does not restrict a company's competitiveness. The driving force in voluntary regimes includes along-with institutional investor participation, shareholder activism as well, wherein they both amalgamate to ensure disclosures are made to follow compliances based on corporate governance norms.[112] This was observed when Canadian companies which wished to compete in the US actively prescribed legislative initiatives such as the Sarbanes-

[110] ASX Corporate Governance Council, 'Corporate Governance Principles and Regulations', available at: https://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-fourth-edn.pdf accessed 1 September 2021.
[111] Global Legal Post, 'Report finds ESG impacting debt raising for UK corporates', available at: https://www.globallegalpost.com/big-stories/report-finds-esg-impacting-debt-raising-for-uk-corporates-50565898/ accessed 30 August 2021.
[112] SSRN, 'Corporate Governance In India: The Transition From Code To Statute', available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3173591 accessed 29 August 2021.

Oxley Act of 2002 followed in the US to showcase their investor support favoured compliances.[113]

Presently, with the ongoing Pandemic, companies with more robust ESG records will globally be seen as "Alpha" as they will outperform their competition by having less volatility and holding less downside risk.[114] For Indian companies to become international champions, they must match the global uptrend in corporate philanthropy and ethical CSR practices. The present Indian CSR model does not fall within this realm because philanthropy, by its very essence, is voluntary, additionally includes a plethora of fields to help in, whereas not only does the Indian model mandate companies to participate in forms of philanthropy, by defining its scope, limits companies from re-imagining the scope of the same. This pushes companies to venture around CSR options that resonate with the company's core competence, being a branding tactic.[115] This requires a close inspection of voluntary international regimes and international strategies.

In the United States, social policies have become essential to investors over the years and have become vital in increasing share performance.[116] The general application of CSR comes in tandem with referring to the Stakeholder theory, in which presently, given the

[113] Nomura, The Covid-19 Crisis will Accelerate the Adoption of ESG Policies', available at: https://www.nomuraconnects.com/focused-thinking-posts/the-covid-19-crisis-will-accelerate-the-adoption-of-esg-policies/ accessed 29 August 2021.
[114] *Id.*
[115] Pushpa Sundar, 'Is Mandated Philanthropy Doing Indian Society Any Good?' (*The Wire*, 5 April 2017), available at: https://thewire.in/society/is-mandated-philanthropy-doing-indian-society-any-good accessed 23 August 2021.
[116] *Id.*

Pandemic, preference is placed on employees. Unlike the Indian system, which is rigid when dealing with employees as stakeholders, the general understanding in the US is that Covid being a critical time, there is a requirement for employees and employers to build a deeper relationship of trust and loyalty.[117] Adopting "employee-protecting policies" is crucial to optimise the running and smooth operations of the company. This also increases support in an employee's reaction and cooperation when a company chooses other stakeholders such as consumers, community, shareholders, and investors.[118] In the past, such a model has allowed companies to step up and create strategies and social policies that would best cater to the situation at hand while retaining a broad scope of doing CSR. For example: "Ford Motor offered free vehicles to fire and rescue agencies during wildfires in California, while many pharmaceutical companies also donated drugs and medical supplies."[119] Coke provided vaccination, PPE kits, other amenities for its employees and customers, virtual auditing sessions, and funding several domestic and international NGOs.[120]

Additionally, while CSR has predominantly matured in various jurisdictions, it has been seen as a possible solution to combat Covid-19 globally. Internationally, there has been more profound development towards understanding risk management with the ambit of a company's social obligations. EU places a significance on due

[117] Appel Mahmud, Ding and Morshadul Hasan, 'Corporate Social Responsibility: Business Responses to Coronavirus (COVID-19) Pandemic' (2021). SAGE Open.
[118] *Id.*
[119] *Sundar* (n 40).
[120] The Coca Cola Company, 'Business and Environmental, Social and Governance Report', available at: https://www.coca-colacompany.com/content/dam/journey/us/en/reports/coca-cola-business-environmental-social-governance-report-2020.pdf accessed on 11 May 2021.

diligence requirements within its CSR duties, whereas, primarily, company law rules are within the ambit of national laws and have not become supranational. Hence, laws of the country wherein the company has been incorporated seek precedence, while ancillary requirements can be invoked based on domestic regimes. While EU does not mandate CSR practises through legislative actions, in France, as per a reformation of the Civil Code 2019,[121] it was suggested that "the social and environmental stakes linked to its activity." Previously, France solely prioritised its shareholders' interests, whereas such a shift suggests preference towards CSR policies. Additionally, given that a mandatory due diligence requirement is in place, as per the French Duty of Vigilance Law (2017),[122] Companies have a requirement to implement measures to preserve "human health and safety."[123] Through this legislature, companies are required to set their vigilance plan based on the legislature's scope and identify their vigilance measures based on their risk assessment. At the same time, the failure to not comply would place a financial liability. Here it is interesting to see the amalgamation of corporate flexibility and yet traces of the mandatory regime. This allows them to accommodate Covid as a risk assessment and implement the same.

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121 European Parliament Committee, 'Corporate social responsibility and its implementation into EU Company law', available at: https://www.europarl.europa.eu/RegData/etudes/STUD/2020/658541/IPOL_STU(2020)658541_EN.pdf accessed at 11 August 2021.

122 Business and Human Rights Resource Centre 'French Duty of Vigilance Law - English translation', available at: https://www.business-humanrights.org/en/latest-news/french-duty-of-vigilance-law-english-translation/ accessed 11 August 2021.

123 'Covid19 -Oxygen Shortage: Delhi High Court Hearing-Live Updates' *LiveLaw*, (22 April 2021), available at: https://www.livelaw.in/top-stories/covid19-oxygen-shortage-delhi-high-court-hearing-live-updates-172941 accessed at 10 August 2021.

While Italy does not have a mandatory regime, there is a push to adopt UN Guiding Principles called the "231 models" that deal with risk mitigation measures."[124] Importance is placed on soft law instruments such as international instruments like OECD Guidelines, which provide recommendations to address adverse impacts on workers, relevant corporate governance, violations to human rights, and impact on the community and environment under the context of CSR. Similarly, the principles under the ILO Tripartite Declaration on Multinational Enterprises and Social policy.[125] It is required for the facilitation of responsible, inclusive, and sustainable workplaces. The larger goal is to encourage companies to strengthen their "self-regulatory system" to deal with risks such as placing employees', customers', and communities' health at risk, then mandating the official report on risk assessment to include health and safety during work.

V. LESSONS FOR INDIA

Globally reflecting on international practices will help India mitigate the ongoing crises, especially as domestic judiciary organs believe that

[124] ITALIAN LEGISLATIVE DECREE No. 231/2001, 'A model for Mandatory Human Rights Due Diligence Legislation?', available at: https://media.business-humanrights.org/media/documents/files/documents/report_231_2001_ENG.pdf accessed at 11 August 2021.
[125] International Labour Organization, 'Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy, available at: https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/---multi/documents/publication/wcms_094386.pdf accessed at 11 August 2021.

Corporations support will be crucial in recovering and recuperating from covid-19.[126]

From the abovementioned assessment, two points can be highlighted: the 'social' component within ESG needs to hold the viewpoint of risk assessment for stakeholders such as employees, investors, and internal management. At the same time, corporate philanthropic elements are required to cater to external stakeholders such as customers and society at large. At present, India is restricted in catering specifically to these stakeholders' needs, resulting in losing its global and domestic investors' trust and eroding its loyalty amongst employees. Also largely failing to become the economic pillars of strength for the community its faithful customers reside. One reason for this was, as mentioned earlier, the restrictive nature of the mandatory CSR compliance, in addition to the ambiguity in covid-19 related circulars. Another is the lack of imagination in CSR and social obligations within the domestic legislation to incorporate the pandemics, shocks and risks within its scope. It is then urging to introspect international policies and strategies.

While in India, there is a lack of focus in CSR mandates which encourage programs to combat major communicable diseases or to envisage a specific Action Plan for Covid-19 beyond simply contributing to a national disaster relief fund. Broadly, the global understanding of CSR is one that would mitigate a business's negative externalities beyond the primary legal, due diligence compliances.[127]

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[126] EPC (n 46).

[127] ECGI Global Corporate Governance, 'The Covid-19 Crisis And Its Aftermath Corporate Governance Implications And Policy Challenges', available at: The

Therefore, globally, it has been observed that reducing the spread of COVID-19 would fall within this mitigation. In Japan, this dynamically resulted in companies actively shutting their shops and events voluntarily, employees adopting work from home without there being any government-mandated curfew and taking other such steps that can help in mitigation.[128]

Similarly, in Singapore, preference was given to firms to choose their CSR funds to curb the Pandemic and build a social capital amongst their stakeholders by catering to specific social responsibilities directly affecting them;[129] this allows companies to create internal hubs for mitigation when providing employees, management and customers with vaccines. A chain of such corporations working in tandem with welfare government policies can also fasten a country's vaccination and recovery rate. Then being a helpful strategy in India given the vast and diverse socio-economic demographics can deeply benefit from

An interesting takeaway was looking at detailed due diligence and risk assessment strategy adopted within the EU's CSR regime to optimise both a business continuity plan (BCP) while considering having to fulfil its social responsibilities for its communities at large.[130] A more extensive assessment understood that the Pandemic had taken away

COVID-19 Crisis and Its Aftermath: Corporate ...https://ecgi.global › content › covid-19-crisis-and-its-after... accessed 19 August 2021.

[128] *Id.*

[129] ECGI Global 'The Covid-19 Crisis And Its Aftermath Corporate Governance Implications And Policy Challenge', available at: The COVID-19 Crisis and Its Aftermath: Corporate ...https://ecgi.global › content › covid-19-crisis-and-its-after... accessed 10 August 2021.

[130] *Id.*

several part-time, full-time workers and labour force; additionally, the frontline employees are exposed to Covid-19 while only having minimal protection. Hence, countries in the EU have due diligence mechanisms as part of their CSR regime, as in the case of France's Vigilance Act that prioritises the health and safety of its workers. India, unfortunately, cannot and has not been so creative with its imagination of CSR as it has been dominated through mandatory policies.

VI. LIMITATIONS

Regardless, there are certain limitations that India would need to consider when incorporating foreign initiatives. Firstly, it is imperative to understand that India, unlike other first world countries, is densely populated and has a profoundly varied and affluent demographic. These factors in the geographical impacts between cities and towns infrastructure alongside the economic or medical facilities in each region make administrational facilities extremely over-burdened. Thus, making the uniform distribution of resources difficult, given that even prior to the Pandemic, the administration, medical or financial infrastructures were burdened and not prepared to support a shock as the Pandemic.

Secondly, voluntary regimes such as Japan work because there is a predominance of practising tort law; hence in the event that an employee or a customer contracts Covid-19, the company shall be sued.[131] Whereas, in India, tort law has several compliance and administrative issues, neither has it comprehensively been established

[131] *Sundar* (n 40).

as an effective redressal measure.[132] Then requiring that the government places specific mandates through legislative actions like circulars to enforce certain measures such as social distancing measures. Thirdly, while there is a trend amongst international investors to invest in sustainable, social, or environmental strategies, the same psychology has not been actively seen in Indian investors, as a result of which ESG strategies has not been holding a cluster effect.[133]

Fourthly, unlike Singapore or other international corporate hubs at present, the Indian corporate system is not uniformly placed or evenly numbered to create multiple international stakeholder assessment hubs and mitigate the effects of the Pandemic in tandem with government policies across all demographics.[134] Lastly, India is a dualistic country and requires legislative action to incorporate international soft law practices within its regime.[135] Hence, policies such as the UN Guidelines "231 model" followed by Italy, or

[132] R Ramamoorthy, 'Difficulties Of Tort Litigants In India.' (1970) 12 JILI, 321.
[133] Money Control, 'ESG is a nascent concept in India, but it has already begun impacting stock prices and valuations', available at: https://www.moneycontrol.com/news/business/personal-finance/esg-is-a-nascent-concept-in-india-but-it-has-already-begun-impacting-stock-prices-and-valuations-says-harsha-upadhyaya-president-cio-equity-kotak-mahindra-asset-management-company-6730341.html accessed on 9 August 2021.
[134] MSG, 'How Singapore Became a World Class Regional Financial and Commercial Hub', available at: https://www.managementstudyguide.com/how-singapore-became-world-class-regional-financial-and-commercial-hub.htm accessed 10 July 2021.
[135] Indian Society of International Law, Springer, 'India and international law: formal dualism, functional monism', available at: https://library.unej.ac.id/repository/_Indian_Journal_of_International_Law0A.pdf accessed 10 August 2021.

UNCTAD's investment policies suggestions without a legislative action to incorporate and legitimise these international practices.

VII. THE WAY FORWARD

As discussed in earlier topics, the mandatory CSR regime in India creates a rigid structure for corporations. To avoid the free flow of CSR activities and give companies a breather, many jurists have argued that the minimum limit of 2 % should be reduced according to the company's earning ability.[136] Moreover, CSR is moral steps and not taxes which should be blanketly mandated. In a voluntary regime, the first year may see a few firms complying with the voluntary code. Over time, more and more firms may comply, increasing compliance and continuing to do so after that. The clustering effect is a market apparatus that can occur without the presence of legal rules.[137] The CSR study of 2015 finds that many companies have scaled up operations in CSR and are looking at it as a priority, with Mahindra and Mahindra leading the pack. Compared to the previous study, it has jumped two ranks. There are four Tata group companies in the top 10 list. This shows that companies like in voluntary regimes have taken initiatives and can start a cluster effect, as mentioned above, even without mandatory obligations. The easing of the obligations will automatically incentivise more companies to invest in India.

Interpretation of government circulars to include or not include specific CSR activity is another problem that companies face, which

[136] *CORE UK* (n 20).
[137] Anand, Anita Indira. "Voluntary vs Mandatory Corporate Governance: Towards an Optimal Regulatory Framework." (2005). Semantic Scholar.

prevents them from taking swift and speedy actions. In light of the same, Schedule VII of the Companies Act should be more liberally interpreted, especially a leeway should be given in times of crisis like the current one. A positive step in this direction is the release of a SEBI Circular dated 10th May 2021,[138] that mandates a new ESG parameter this being a reporting requirement called the "Business Responsibility and Sustainability Report" (BRSR). This reporting compliance is centred around the nine principles of the "National Guidelines on Responsible Business Conduct". These broad principles include prioritising providing goods and services in a sustainable manner, creating a respectful work environment, protecting human rights, restoring the environment, forming a transparent and responsible business practice, promoting equitable development within the internal divisions, and responsibly engaging with all stakeholders or customers[139]. Each are framed to clearly provide Companies with a large aim and certain core elements that need to be complied with, allowing companies the scope to liberally apply internal policies which would further incentive more businesses to voluntarily take ESG initiatives, thus pushing the Indian market towards the voluntary regime as well. Sensing this push, as the Circular also specifies that as these principles will further be categorised into essential and leadership indicators, reporting essential shall only be mandatory while leadership will be voluntary. An added advantage of these principles and the reporting compliance is the comparability of ESG parameters in companies, as it is based on the

[138] Circular SEBI/HO/CFD/CMD-2/P/CIR/2021/562 (SEBI Circular) and in line with the amended Clause 34(2)(f) of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Amendment).

[139] National Guidelines on Responsible Business Conduct, available at: https://www.mca.gov.in/Ministry/pdf/NationalGuildeline_15032019.pdf accessed 11 august 2021.

nine parameters, which would allow investors to make better investment decisions.

With this being a promising beginning, there is a need for more progressive and robust compliance ESG requirements such that they play a massive role in incentivising investments by crossing the lines of voluntary and mandatory regimes. Alleviating the administrative burden for firms and reducing bureaucratic obstacles contributes to more efficient production processes and faster delivery of much-needed goods to clients during the Pandemic.[140] Further, making positive changes towards the social domain in ESG will not only result in result in positive ESG reports for the companies but also will help in mitigating further emergencies and crises. Additionally, certain policy suggestions proposed by UNCTAD,[141] these being supporting local SMEs or acquiring shares of crisis-affected companies and compelling government companies to invest in covid related facilities would require policy action. An example is the US government ordering government-funded car manufacturing companies to produce medical ventilators under its Défense production Act 1950. Since such an initiative on the Indian front would require indulging in administerial and bureaucratic measures, this paper refrained from further indulging. Regardless, making positive changes towards the social domain in ESG will result in positive ESG reports for the companies and help mitigate further emergencies and crises.

[140] Investment Policy Monitor UNCTAD, 'Investment Policy Responses To The Covid-19 Pandemic', available at: https://unctad.org/system/files/official-document/diaepcbinf2020d3_en.pdf accessed 13 august 2021.
[141] *Id.*

VIII. CONCLUSION

From the abovementioned discourse, it is clear that these testing times require creative and prompt measures to strategise and combat Covid-19 while allowing for companies to retain their competitive edge and incentive investing. Given the global shock, a larger preference is now given to prioritising a company's ESG mechanisms as it ensures that a company mitigate its risks and is not highly volatile. Along-with which the favourable implication would be acknowledging that meeting the needs for social compliances within ESG companies could further mitigate the spread of Covid-19 as well. This is based on several jurisdictions' that CSR is primarily done to mitigate negative externalities such as the spread. In comparison, the social aspect and CSR should include risk assessment of employees and other stakeholders' health and safety. The issues highlighted in the paper were twofold, one being the strict compliance with CSR rules that do not allow for the dedication of CSR activities amongst internal stakeholders. Other is the lack of imagination of the scope of CSR to accommodate ad-hoc and flexible needs based on current socio-economic issues such as the Pandemic created crises. This is reflected in the paper's assessment on international jurisdictions, a comparative analysis between voluntary and flexible mandatory regimes. To conclude, amongst the lessons and way forward incorporated, there needs to be a scope to leave the mandatory regime such that they carry on positive cluster effects and have specific favourable outcomes like high compliance levels. It is now up to Indian companies to step up its game and become socially responsible global leaders.

PRINCIPLE OF REFLECTIVE LOSS: REVISITING THE RULES OF CORPORATE GOVERNANCE

Bakhshind Singh[142] and Khushi Sharma[143]

ABSTRACT

The Reflective Loss rule prevents the shareholders of a company from personally recovering the damages suffered due to either depletion in value of their shares or a diminution in the dividends receivable. The under-structure of the rule gathers its strength from two important company law principles - first, the rule of separate legal identity; and second, the proper plaintiff rule. Conjoint applicability of these principles leads to the inference that in cases where a company has suffered a loss due to wrongdoers, it is the company itself which must sue, being the proper plaintiff, and not the shareholders thereof.

The rule has remained applicable to the shareholders since its very inception. However, its applicability to creditors has intrigued several discussions among legal scholars of different common law jurisdictions, which were recently settled by the UK Supreme Court in Sevilleja v. Marex Financial Ltd., which held that the rule does not extend to the creditors.

The authors shall discuss the possible approaches that Indian Courts may adopt when propounded with a similar question, given that India follows the English pronouncements to substantiate its corporate law

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framework while being mindful of the fiduciary duties that the directors owe to the creditors in the Indian scenario.

I. INTRODUCTION

The *Reflective loss rule* is a relatively new principle of company law, having its origin in the UK Court of Appeal's case of *Prudential Assurance v. Newman Industries*.[144] The rule provides that if a loss is suffered by a company leading to depletion in the value of shares, then the shareholders are barred from bringing an individual claim against the wrongdoers because the shareholders' loss is a mere reflection of the loss that the company has suffered. The rule underwent a prime development in a UK Supreme Court (**"UKSC"**) judgement of *Sevilleja v. Marex Financial Ltd.*, wherein the scope of reflective loss rule was re-examined.

In this article, the authors shall explicate the rationale behind the reflective loss rule while unravelling its scope and ambit. Moreover, the authors shall also undertake an analysis of the applicability of the doctrine in other common law jurisdictions. Lastly, an analysis shall be undertaken to scrutinize the implications of this doctrine in India.

II. RATIONALE BEHIND THE REFLECTIVE LOSS RULE

The premise of this rule is based on the principle that a company is a separate legal entity[145] coupled with the proper plaintiff rule which

[144] [1982] Ch 204, [1982] 1 All ER 354.
[145] *Salomon v. Salomon* [1896] UKHL 1, [1897] AC 22(HL).

provides that in case a wrong has been done to the company, then the proper plaintiff in such a case should be the company itself.[146] It is only under exceptional circumstances, wherein the company cannot sue the wrongdoers, should the shareholders be allowed to sue on behalf of the company.[147] These circumstances include fraud on minority shareholders by those in control of the company,[148] the majority undertaking an *ultra vires* transaction or an illegal act,[149] and the majority purporting to undertake an act by ordinary resolution which requires a special resolution.[150]

Another reason behind the applicability of the reflective loss rule, as suggested in *Johnson v. Gore Wood & Co.*, was to avoid the problem of double recovery of claims, because in such cases, both the company and the shareholders have a concurrent right of recovery concerning the same debt.[151] The wrongdoers, in such cases, must be directed to compensate the company itself as replenishment of the company's assets would automatically restore the value of shareholding to its original position.[152] Moreover, if the shareholders are allowed to claim losses, it would mean two different parties claiming the same loss, thereby causing prejudice to the defendants.[153]

[146] *Foss v. Harbottle* [1843] 2 Hare 461, [1843] 67 All ER 189.
[147] *Edwards v. Halliwell* [1950] 2 All ER 1064 (CA).
[148] *Giles v. Rhind* [2002] EWCA Civ 1482, [2003] Ch 618.
[149] *MacDougall v. Gardiner* [1875] 1 (Ch) D 13.
[150] R. Gregory, 'What Is the Rule in Foss v. Harbottle?' (1982) 45 Mod LR 584,587.
[151] *Johnson v. Gore Wood & Co.* [2000] UKHL 65, [2002] 2 AC 1 (HL).
[152] Bas De Jong, 'Shareholder's Claims for Reflective Loss: A Comparative Legal Analysis' (2013) 14 Eur Bus Org LR 97, 98.
[153] *Atlasview Ltd. v. Brightview Ltd.* [2004] EWHC 1056 (Ch), [2004] 2 BCLC 191.

III. SCOPE AND AMBIT OF THE REFLECTIVE LOSS RULE

The ambit of applicability of the reflective loss rule at its initiation was narrow enough to only bar the shareholders of the company from bringing an action against the wrongdoers.[154] The rationale behind the same was not only to avoid the problem of double recovery but also to ensure that proliferation of claims does not lead to shareholders preventing the company's management from taking appropriate actions in the interest of the company.[155]

A. AUGMENTING THE SCOPE OF THE REFLECTIVE LOSS RULE

However, with time, the scope of the reflective loss rule witnessed expansion beyond the shareholders in the English jurisdiction. In *Johnson v. Gore Wood & Co.*,[156] wrongdoers committed fraud on the company, by virtue of which the employees could not be paid salaries. When the employees brought a claim against the wrongdoers, Lord Millet was of the view that the reflective loss rule extends to all the claims and payments which the company would have made had it not been deprived of the funds by the wrongdoers, irrespective of the type of claim.[157] This case, therefore, expanded the rule to encompass employees of the company and barred the claims brought by them.[158]

[154] *Sevilleja v. Marex Financial Ltd.* [2020] UKSC 31, [2020] 3 WLR 255.
[155] *Id.*
[156] *Johnson* (n 8).
[157] *Johnson* (n 8).
[158] Ivan Sin, 'The No Reflective Loss Principle in Marex v. Sevilleja: One Step Forward, One Step Back' [2020] J of Bus L 1,7.

Creditors were also brought within the ambit of reflective loss rule by way of the case of *Gardner v. Parker*, wherein it was held that if a loss occurred to the creditors is, in essence, a reflection of the loss that the company has suffered, then the creditors shall be barred from bringing a claim against the wrongdoers.[159]

According to the above-stated and several other decisions,[160] the reflective loss rule had established its ground in the common law jurisdictions, specifically concerning its applicability to the shareholders. However, the application of this rule to secured creditors remained a point of contention, as it would be unjust to the creditors if they were unable to recover their money due to a wrong committed on the company. This debate was ultimately put to rest by the UKSC in the *Marex Case*, wherein the scope of reflective loss rule witnessed confinement, and creditors were expunged from the ambit of reflective loss rule.

B. (RE)CONFINING THE SCOPE OF REFLECTIVE LOSS RULE

The UKSC, when provided with the first opportunity to settle the scope of the reflective loss rule in the *Marex Case*, confined the same to shareholders of the company. This was a case wherein a company was asset-stripped by its director, to defraud one of its creditors, Marex, who later brought an action against the director in torts. The director's defence was that the loss suffered by Marex was reflective

[159] *Gardner v. Parker* [2004] EWCA Civ 781, [2004] 2 BCLC 554 (CA).
[160] *Stein v. Blake* [1998] 1 All ER 724*; Heron International Ltd v Lord Grade* [1983] BCLC 244*; George Fischer (Great Britain) Ltd v Multi Construction Ltd* [1995] 1 BCLC 260*; Gerber Garment Technology Inc v Lectra Systems Ltd* [1997] RPC 443.

of the loss suffered by the company and hence barred under the reflective loss rule.[161]

Marex's claim was accepted by the Court of first instance. The Court of Appeal, however, overturned the decision rendered by Commercial Court by following the ratio of *Gardner v. Parker*[162] and stated that the loss suffered by Marex is a reflection of the loss suffered by the company and therefore, only the company is the proper plaintiff to bring the claim.[163]

Marex preferred an Appeal before the UKSC, wherein the Court of Appeal's decision was also reversed, and the case was ultimately decided in favor of Marex. The majority narrowed down the ambit of reflective loss to solely bar the shareholders and that too under two circumstances: *first, when there is* depletion in value of shares, and *second*, when there is a diminution in the dividend receivable.[164]

The decision of the UKSC has completely ruled out the inclusion of creditors from the ambit of reflective loss rule on the premise that there lies a distinction between losses suffered by creditors due to depletion in value of assets of the company and those suffered by the shareholders. The loss in value of shares cannot be regarded the same as loss in value of debt as the latter is not affected by a change in assets

[161] *Marex* (n 11).
[162] *Gardner* (n 16).
[163] *Sevilleja v. Marex Financial Ltd.* [2018] EWCA Civ 1468, [2019] QB 173.
[164] Paul Davies QC (hon), 'Reflecting on Sevilleja v Marex Financial' (*Oxford Business Law Blog*, 15 October, 2020), available at: https://www.law.ox.ac.uk/research-subject-groups/commercial-law-centre/blog/2020/10/reflecting-sevilleja-v-marex-financial accessed 31 July 2021.

of the company.[165] This distinction was further elucidated upon by Lord Reed through his statement:

Where a company suffers a loss, it is possible that its shareholders may also suffer a consequential loss in respect of the value of their shares, but its creditors will not suffer any loss so long as the company remains solvent. Even where a loss causes the company to become insolvent, or occurs while it is insolvent, its shareholders and its creditors are not affected in the same way, either temporally or causally.[166]

Therefore, if creditors of a company suffer a loss, they are entitled to initiate a personal action against the directors of the company because it does not give rise to a conflict with the proper plaintiff rule laid down in *Foss v. Harbottle*.[167] This narrow scope of reflective loss rule has further solidified its position in the UK by the decision of England & Wales High Court in *Broadcasting Investment Group Ltd & Ors. v. Smith & Ors*.[168] However, the ambit of reflective loss rule in other common law jurisdictions, particularly with respect to the claims brought by creditors, remains to be examined.

165 *Marex* (n 11) [84].
166 *Id.* [85] (Lord Reed) (footnotes omitted).
167 *Id.*
168 [2020] EWHC 2501 (Ch).

IV. ADOPTION OF THE REFLECTIVE LOSS RULE: COMMON LAW JURISDICTIONS

Several common law jurisdictions have taken a broad view regarding the English principle of reflective loss, barring creditors from pursuing claims for losses that reflect the losses suffered by the company. However, these jurisdictions have varying perspectives on the rationale for applying the principle to the company's creditors.

In Singapore, the claims of the creditors are subject to the reflective loss rule on the sole premise of avoiding double recovery. In the case of *Townsing v. Jenton Overseas Investment Pte Ltd,*[169] the Singapore Court of Appeal stated that if the plaintiff can prove that efforts were made or would have been made to eliminate the potential risk of double recovery, the court may be inclined to disregard the rule. On the flip side, in the Cayman Islands, even though the creditors' claims are within the purview of the reflective loss rule, the Court of Appeal in the *Primeo Judgement*[170] has relinquished avoidance of double recovery as the sole consideration for the rule. Instead, the main considerations include avoiding prejudice to minority shareholders and other creditors, as well as preventing individual plaintiffs from 'scooping the pool'.[171]

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[169] [2007] SGCA 13, [2008] 1 LRC 231 [77] (12 March 2007) (Singapore).

[170] *Primeo Fund (in Official Liquidation) (Primeo) v. Bank of Bermuda (Cayman Limited) & HSBC Securities Services (Luxembourg) SA (HSSL)* [2017] 2 CILR 334 (Cayman Islands).

[171] Andrew Tarnowskyj and Seamus Brand, 'Court of Appeal Takes a Hard Look in the Mirror: the Policy Behind Reflective Loss' (*The LK Blog,* 4 July 2019), available at: https://www.lk.law/2019/07/court-of-appeal-takes-a-hard-look-in-the-mirror-the-policy-behind-reflective-loss/ accessed 3 August, 2021.

It is worth noting that the avoidance of double recovery is not the only rationale for allowing the principle to be applied to creditors. In the US case of *Production Resources Group, LLC v. NCT Group Inc.*,[172] the Delaware Supreme Court opined that in case of mismanagement of the corporation, it is the company who suffers the injury and any losses incurred by the creditors or the shareholders are purely derivative of the 'direct financial harm to the corporation'. Therefore, such claims only belong to the corporation, and any loss incurred by creditors is solely due to the diminishing value of the company and the assets from which debt may be recovered.

A similar rationale was provided in the case of *North American Catholic Educational Programming Foundation Inc. v. Gheewalla,*[173] wherein the Supreme Court rejected the contention that directors or the officers owe a fiduciary duty to the company's creditors when it is on the verge of insolvency. It was further held that there is no room for 'direct creditor claims' in case of breach of fiduciary duty by the directors that causes harm to the company and indirect loss to the creditors.

The courts in numerous jurisdictions, including Australia[174] and Hong Kong,[175] have endorsed and followed the broad approach laid down by Lord Millet in *Johnson v. Gore Wood & Co.*,[176] which bars the claims of the creditors when the company has a concurrent right of recovery against the wrongdoer. Nevertheless, following the UK

[172] 863 A 2d 772 (Del Ch 2004) [7].
[173] 930 A 2d 92, 101 (Del 2007).
[174] *Hodges v. Waters* (No 7) (2015) 232 FCR 97 (Australia).
[175] *Waddington Ltd v. Chan Chun Hoo* [2008] 11 HKCFAR.
[176] *Johnson* (n 8).

Supreme Court's judgement in the Marex Case, these countries might reconsider the rationale for applying the reflective loss principle on the creditors of the company.

V. CREDITORS' CLAIMS FOR REFLECTIVE LOSS: INDIAN CONTEXT

In India, the reflective loss rule has not been formally acknowledged. Nonetheless, the 'proper plaintiff rule' has been duly recognized under the Indian jurisprudence[177] and regarded as a variant of the rule.[178] Further, in the case of *Kumar Dutta v. Ruby General Hospital Ltd.,*[179] the Apex Court, while analyzing foreign jurisprudence, held that in case of mismanagement of the company's affairs by the directors, the shareholders cannot recover compensation for the loss they have suffered as a result of subsequent diminution in value of their shares, and they cannot achieve this indirectly by suing the directors for conspiracy to breach the duties which they owed the company.[180]

It is evident that even though the reflective loss rule is not directly addressed in Indian law, it has been recognized *sub silentio* via adopting the proper plaintiff rule, implying that shareholders are prevented from bringing an individual action to recover damages that

[177] *Dr. Satya Charan Law v Rameshwar Prasad Bajoria* AIR 1950 FC 133, 681; *S. Manmohan Singh v S. Balbir Singh* ILR 1975 427 (Del); *Supriya Gupta v J.K. Jain* (2009) SCC OnLine Del 3021.
[178] *Jenton* (n 25) [78].
[179] (2006) 7 SCC 613.
[180] *Id.* [43].

occur solely as a result of the company's losses. However, it is still unclear if the creditor's claims fall within the ambit of this rule.

A. APPLICATION OF THE RULE TO CREDITORS

It is settled law that directors owe a fiduciary duty to the company[181] and do not owe any contractual duty, fiduciary duty, or duty of care to the third party dealing with the company.[182] It is apposite to note that in the case of *Tristar Consultants v. V Customer Services India Pvt,*[183] Delhi High Court held that liability of the directors towards third parties is limited to two circumstances, 'First, when directors make themselves personally liable by executing personal guarantees, indemnities, etc., and second, when the director induces a third party to act to his detriment by advancing a loan or money to the company'.[184] Further, in the case of *Mukesh Hans & Another v. Smt. Uma Bhasin & Others,*[185] it has also been held that the liability of directors towards the creditors does not flow from a contract but rather flows from action in tort for malfeasance and misfeasance.

Therefore, it can be held that creditors are barred from bringing claims against the directors for debts owed by the company. Any loss suffered by the creditors, due to misapplication of assets by the directors, is merely consequential of the harm suffered by the company. The director's liability towards third parties is limited to action in torts for

[181] The Companies Act 2013, s 166 (India); *Sangarmsinh P. Gaekwad v Shantadevi P. Gaekwad* (2005) 11 SCC 314.
[182] *Hrushikesh Panda v. Indramani Swain* AIR 1987 Orrisa 79 [12].
[183] (2007) 139 DLT 688.
[184] *Id.* [28].
[185] 2010 SCC OnLine Del 2776.

fraudulent misrepresentation and inducing the third party to act to his detriment and part with money.[186]

From the above stated judicial precedents, it can be inferred that the application of the rule on the creditors of the company is not absolute in India. However, at this juncture, it is also pertinent to examine the statutory framework to determine various duties of the director towards the creditors and the liabilities they may incur if they do not take cognizance of such duties.

B. DUTIES OF THE DIRECTORS

As mentioned above, directors owe a fiduciary duty to the company and have to act in the best interest of the company.[187] However, prior to the enactment of the Companies Act, 2013, the duties of the director were not laid down in explicit terms. Previously, such duty stemmed from the fact that the directors held a position comparable to trustees or agents for the company.[188] The only provision that was enforceable against the directors for the breach of this duty was Section 88 of the Indian Trusts Act, 1882.[189] The provision binds the directors to act in a fiduciary capacity and prevents them from making unjust enrichment or an unjust benefit at the cost of the beneficiary. Finally, it was through the recommendation of the JJ Irani Committee,[190] that

[186] *Id.* [11].
[187] The Companies Act 2013, s 166 (India); *Sangarmsinh P. Gaekwad v. Shantadevi P. Gaekwad* (2005) 11 SCC 314.
[188] *Faith Mercantile Pvt. Ltd. v. Simbhaoli Sugar Ltd.* 2018 SCC OnLine 10772 [9].
[189] The Indian Trusts Act 1882, (India).
[190] JJ Irani, Ministry of Corporate Affairs, *Report of the Expert Committee on Company Law* (2006).

the duties of the directors were specified in Section 166 of the Companies Act, 2013.[191] Currently, the Section reads as:

166. Duties of directors

(1) Subject to the provisions of this Act, a director of a company shall act in accordance with the articles of the company.

(2) A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, and the community and for the protection of environment.

(3) A director of a company shall exercise his duties with due and reason- able care, skill and diligence and shall exercise independent judgment.

(4) A director of a company shall not involve in a situation in which he may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company.

(5) A director of a company shall not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates and if such director is found guilty of making

[191] The Companies Act 2013, s 166 (India).

any undue gain, he shall be liable to pay an amount equal to that gain to the company.

(6) A director of a company shall not assign his office and any assignment so made shall be void.

(7) If a director of the company contravenes the provisions of this section such director shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

It is implicit from the antecedent that the provision does not expressly mention the director's duties towards the creditor. Moreover, there is no judicial precedent to suggest that the creditors have the right to file claims against the directors for violation of this provision. Nevertheless, if the creditors are unable to recover the debt owed by the company, on account of the director's misconduct, they have legal recourse in the form of a tort claim or insolvency petition under the Insolvency and Bankruptcy Code, 2016 ("IBC").[192]

It is an accepted principle of Insolvency law that during the twilight period,[193] i.e., when the company is on the verge of insolvency, directors have certain responsibilities towards the creditors of the company.[194] Section 66 of the IBC recognizes this specific duty of the

[192] The Insolvency and Bankruptcy Code 2016, (India). [hereinafter "IBC"]
[193] D. Milman, 'Strategies For Regulating Managerial Performance In The 'Twilight Zone' –Familiar Dilemmas & New Considerations' (2004) 4 Journal of Business Law 493.
[194] S. Preetha, 'The Fraudulent Trading Offence: Need For A Relook' (2011) 4 NUJS Law Review 231, 233.

directors.[195] Under this provision, the directors are liable to contribute to the assets of the corporate debtor if they conduct the business of the corporate debtor fraudulently with an intent to defraud the creditors,[196] or if 'they knew or ought to have known that there was no reasonable prospect of avoiding the commencement of corporate insolvency resolution'[197] and still 'did not exercise due diligence in minimising the potential loss to the creditors of the corporate debtor.'[198] It is interesting to note that, even though the director's duties become more creditor-centric during the twilight period, the directors are only obligated to compensate the company by contributing to the assets.[199] Existing law does not imply that creditors must be paid directly or that they have the right to sue the directors.

In view of the same, it could be argued that the legislative framework appears to be predisposed towards barring the creditors' claims under the reflective loss rule. Directors owe a fiduciary duty to the creditors only under specific circumstances and in the event of a violation, claims can only be pursued under torts. Although, it is worth emphasizing that tort claims can be brought by the creditors only when the loss suffered is direct. Creditors cannot make the directors liable by suing them in tort even for the mismanagement of the company's affairs.[200] In such an event, the loss suffered by the creditor is only a derivative of the company's loss since the injury is caused by a reduction in the availability of the corporation's assets to pay off the

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195 IBC, s 66.
196 IBC, s 66(1).
197 IBC, s 66(2)(a).
198 IBC, s 66(2)(b).
199 IBC, s 66(2).
200 *Hrushikesh Panda v. Indramani Swain* AIR 1987 Orrisa 79 [12].

creditors.[201] Accordingly, if the directors have not rendered themselves personally liable to the creditors by way of instances mentioned before, the creditors' claims will fall within the ambit of the rule. Therefore, to decide whether a creditor's claim will be barred by the reflective loss rule in India, it must be assessed if the damage incurred is direct or derivative.

VI. CONCLUSION

The UK Supreme Court, through its decision in *Sevellija v. Marex Financial Ltd.,* has demystified a very controversial issue concerning the applicability of the reflective loss rule on the creditors. Through this landmark judgement, the scope of this rule was re-confined to its original position - to the one laid down in *Prudential Case*, as against the expanded scope which had witnessed severe condemnation at the hands of creditors for the reason that creditor's losses are not reflective of the company's losses. The restricted gamut of the reflective loss rule is being celebrated as a welcome decision by the creditors, as its scope has been narrowed down to only cover the shareholders of the company.[202]

However, other common law jurisdictions continue to include creditors in the ambit of reflective loss for several reasons, paramount

[201] *Production Resources* (n 27); *Trenwich Am. Litig, Trust v. Ernst & Young LLP* 906 A 2d 168 (Del Ch 2006).
[202] Stuart Maleno & Anna Shaw, 'Landmark Supreme Court decision narrows the "reflective loss rule" principle' (*Clyde & Co.*, 22 July 2020), available at: https://www.clydeco.com/en/insights/2020/07/landmark-supreme-court-decision-narrows-the-reflec accessed 3August 2021.

of which remains avoidance of double recovery.[203] The UKSC, in *Marex case*, has made it clear that the principle against double recovery does not deflect the law from compensating both claimants. Rather, it affects how both parties get their remedy.[204] Double recovery in cases where a concurrent right of recovery subsists, can be steered clear of by way of procedural mechanisms such as subrogation[205] or in cases where one of the parties has been ousted from bringing a claim, by imposing an obligation on the other party to compensate the excluded party out of the damages received.[206]

As far as applicability of this rule to India is concerned, from the limited jurisprudence available, it is clear that a creditor's right to pursue a claim against the company's wrongdoer is circumscribed in India. There is a higher threshold for holding the directors liable for their misconduct. As a result, directors are not responsible for breach of duty in all instances. In light of this, mechanical or invariable application of the reflective loss rule to Indian corporate realities would be counterproductive and improper. Nonetheless, it would be fascinating to see how the UKSC judgement affects the corporate climate in other jurisdictions, and how the Indian regulatory framework responds.

[203] *The Halcyon Skies* [1977] 1 QB 14, 32.
[204] *Marex* (n 11) [5].
[205] *Gould v. Vaggelas* [1984] 1 HCA 68.
[206] *O'Sullivan v. Williams* [1992] 3 All ER 385.

BLOCKCHAIN ARBITRATION: A BOON OR A BANE FUTURE DISPUTE RESOLUTION?

Utkarsh Jindal and Harshit Bhimrajka[207]

ABSTRACT

One of the new developments in the age of technology is Blockchain Technology. Technology has the power to modify the perspective on how things are done so far and all the orthodox strategies that our human brain is used to. In simple words, like any other technological development, Blockchain is created to reduce the effort of a person and increase the role of technology to increase productivity for the task concerned. In the technological world, smart contracts have gained a lot of popularity and acknowledgement. In the field of law, the influence of innovations is rising at a mind-blowing pace which is increasing day by day. Although blockchain technology has been one of the most talked about developments in technology in recent years, its effect on legal processes remains to be mysterious. This article details blockchain and smart contracts and their usage in arbitration. In this article, the difference between traditional and smart contracts are summarised. It also explores the Indian scenario and stands on smart contracts.

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I. INTRODUCTION

The advent of Alternative Dispute Resolution (hereinafter referred to as ADR) as a full-fledged process of resolving conflicts can be dated back to 1906 when Roscoe Pound presented his paper titled "The Causes of Popular Dissatisfaction with the Administration of Justice"[208] in which he focused on the "causes lying in the peculiarities of the Anglo American legal system".[209] In his speech, he introduced the novel concept of a multi-door courthouse where he emphasized new integration-doors to access justice in consonance with the approach to resolve legal conflicts and this led to the birth of ADR as a dispute resolution mechanism. Also, his observations on the 'sporting theory of justice'[210] kick-started the beginning of the ADR profession in the world.

Once there was a time when people used to wait many years to resolve their commercial issues. However, now dispute resolution is done in a speedy manner because of the advent of ADR. Similarly, in this current decade, through the introduction of online dispute resolution (hereinafter referred to as ODR), things have become more facile and trouble-free for people to solve their disputes, as they have merged the

[208] West's Encyclopedia of American Law, 'The Causes of Popular Dissatisfaction with the Administration of Justice', available at: https://www.encyclopedia.com accessed 14 December 2021.
[209] Donald L. Swanson, 'The Sporting Theory of Justice" and the Mediation Profession: Roscoe Pound' Mediation Bankry(10 October 2016), available at: https://mediatbankry.com/2016/10/20/how-the-mediation-profession-began-roscoe-pound-1906-part-2-of-2/ accessed 20 December 2021.
[210] Lara Traum and Brian Farkas 'The History and Legacy of the Pound Conferences, Cardozo J. of Conflict Resolution' (2017) 17 Cardozo Journal of Conflict Resolution 677,698.

two most uncomplicated and congenial concepts, i.e., ADR and technology.

Technology has proven time and again that it has the power to change the perspectives of people about how things are done and has introduced many developments to replace the orthodox strategies of humans. In the field of law, innovations are rising at a mind-boggling pace; the most common examples of the same are smart contracts and blockchain arbitration.

Blockchain is one of the most talked-about developments in recent years, as technology has increased the productivity and efficiency of many activities; how efficacious it is in the legal world is still a question that needs a concrete answer. In our day-to-day lives, technology with multidimensional capabilities such as Blockchain could be channelized for various uses. Experts of law have merged this technology with smart contracts by encrypting it through cryptography that makes it operate on the execution of predetermined commands only. Similarly, it has been used with ADR to make the dispute resolution mechanism more effective. Thus, this paper deals with how this technology found its way to the field of ADR as it does with agreements/contracts, further it throws light on the status of blockchain arbitration through an Indian perspective.[211]

II. BLOCKCHAIN ARBITRATION AND SMART CONTRACTS

[211] Allen, W. E. D., Lane A, M., and Poblet, M. 'The governance of blockchain dispute resolution' (2019) 25 *Harvard Negotiation Law Rev*. 75,101.

The word blockchain is one of the most used terms in the 21st century, which has created a vast discussion in the world of digitalization. Though it is very thoroughly used, many people have no idea about the concept. Blockchain is a decentralized platform that distributes digital data on various networks in a secured manner.[212] Blockchain is a very secure virtual system as it secures information in a lot of computers at the same time. Blockchain is defined as a decentralized and immutable digital ledger of transactions.[213] In common parlance, blockchain is understood in the context of cryptocurrencies. The concept of decentralized justice has been adopted in recent years and it is useful for arbitration as well; arbitration is an out-of-court settlement mechanism and blockchain adds greater security to this mechanism, thus increasing confidentiality, one of the main characteristics of arbitration [214]

A. SMART CONTRACTS

Smart Contract is also a rapidly growing idea that means "self-executing electronic instructions drafted in computer code".[215] In layman's terms, they trigger themselves after any condition in the contract is satisfied. In these types of contracts, electronic codes are drafted which are secured with the help of blockchain technology. One of the most important aspects of the smart contract is that it is very

[212] Donata Freiin von Enzberg 'Blockchain- a suitable tool for arbitration' Taylor Wessing, available at: https://iot.taylorwessing.com/blockchain-a-suitable-tool-for-arbitration/ accessed 4 Jan 2022.
[213] Kevin Werbach & Nicolas Cornell 'Contracts Ex Machina', (2017) 67 DUKE L.J. 313, 327.
[214] Darshan Bhora and Aisiri Raj. 'Blockchain Arbitration – The Future of Dispute Resolution Mechanisms?' (2020) Cambridge International law Journal.
[215] R. O'Shields 'Smart Contracts: Legal Agreements for the Blockchain' (2017) 21 NC Bank. Inst. 177, 179,

secure and useful in cases where the intermediary is someone who lacks trust.[216] It also saves any humanly influence on the contract.

Smart contract was developed soon after the groundbreaking discovery of bitcoin. This has made contracts automated, and, with the help of smart contracts blockchain, arbitration can be unprecedented development in the field of dispute resolution as it provides a less halting process and richer functionality.[217] Thus, it becomes easy to make the contract to transfer an asset or to create any kind of business activity which is enforceable between the parties and is completely secure. However, many scholars do not consider smart contract as a legally enforceable and fully formed contract as it lacks the human touch, and many countries don't have provisions in their statute regarding the same.[218]

B. BLOCKCHAIN ARBITRATION

The concept of blockchain arbitration has various important ingredients to it that are automation, irreversible agreements, and virtually costless contractual enforcement mechanisms.[219] It looks attractive due to these features in the completion of arbitration which came into force for its speedy, non-litigating dispute settlement just between the parties. However, such a virtual mechanism in no way ensures an intended result or proper enforcement and there is no way

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[216] *Id.*

[217] Primavera De Filippi & Wright 'Blockchain and the Law-The Rule of Code' (2018) 43 Jstor.

[218] James Grimmelmann'All Smart Contracts Are Ambiguous' (2019) 2 J.L. INNOVATION 1, 2.

[219] Reggie O'Shields 'Smart Contracts: Legal Agreements for the Blockchain' (2017) 21 N.C. BANKING INST. 177, 183.

a layman can foresee each and every contractual dispute so that it can self-execute itself.

Blockchain arbitration mainly provides four ingredients to a contract which are optional- anonymity, experienced arbitrators, automatic decisions, and speed and costs.[220] These ensure the whole aim of arbitration by posting complete anonymity, not just to the third party but also among the disputing parties. This technology allows the system to appoint anyone as an arbitrator which ensures no biasness but there are no specific criteria to be appointed as arbitrator in the same.[221] Speedy resolution and cost-effective are one of the most two important aspects of this technology and which are the sole aim of any disputing party but if the disputes are between two foreign entities and any other method of resolutions are chosen then it becomes very difficult to run things smoothly within the purview of law and resolution becomes very expensive as well.[222]

Blockchain arbitration is generally divided into two parts, the first one

[220] Hausfeld 'How will digital Dispute Resolution Rules for blockchains and digital assets make an impact' ICLG.com (14 June 2021), available at: https://iclg.com/briefing/16543-how-will-digital-dispute-resolution-rules-for-blockchains-and-digital-assets-make-an-impact-united-kingdom accessed 22 Dec 2021.

[221] Daniel J. Neally & Maria L. Hodge 'Blockchain in the Courts' First Annual Dennis Karjala Memorial Workshop (3 November 2018), available at: http://blogs.asucollegeoflaw.com/lsi/files/2018/12/First-Annual-Karjala-Workshop-Report.pdf accessed 25 Decemeber 2021.

[222] The UK Jurisdiction Taskforce 'Arbitration of digital disputes in Smart Contracts and the release of the digital dispute resolution rules' Herbert Smith Freehills (23 April 2021), available at: https://hsfnotes.com/arbitration/2021/04/23/arbitration-of-digital-disputes-in-smart-contracts-and-the-release-of-the-digital-dispute-resolution-rules-from-the-uk-jurisdiction-taskforce/ accessed 9 December 2021.

being the on-chain arbitration and the other one being the off-chain arbitration.

On-chain arbitration includes smart contracts and it is self-executing while the term off-chain means the use of blockchain merely for appointing arbitrators and in most of the work blockchain technology is not used.[223]

III. EVOLUTION OF BLOCKCHAIN ARBITRATION

The advent of cryptocurrencies (i.e., bitcoins, ethereum, etc.) in the year 2009 led to the beginning of the era of blockchain arbitration. E-commerce at that time revolved around the payments in cryptocurrencies that made the anonymous parties to enter a contract using fictional money. Thus, it was obvious that this relationship might led to some disputes that needs to be solved at that time only, and therefore, two models were introduced during that period; *firstly*, a centralized administrator of the marketplace who will decide the cases on merits and, *secondly,* an arbitration platform.[224]

Many disputes started arising with respect to the quality of goods delivered or not delivered at all or scandals like shutting down of

[223] Jenny Cieplak '5 reasons dispute resolution is critical for blockchain's growth' World Economic Forum (14 Dec 2020), available at: https://www.weforum.org/agenda/2020/12/dispute-resolution-is-critical-for-blockchains-successful-growth-heres-5-reasons-why accessed 10 Jan 2022.
[224] Partner Vijay Pal Dalmia 'Blockchain And Smart Contracts – Indian Legal Status - Technology – India' Mondaq, available at: https://www.mondaq.com/india/fin-tech/889458/blockchain-and-smart-contracts-indian-legal-status accessed 3 Jan 2022.

websites after taking the cryptocurrencies. Thus, a central administrator was the lifesaver for the buyers at that time who decided the cases on merit. However, the problem was that he was the only one who executed everything due to which there were many cases of corruption where he did not decide in favor of the victim. For instance, an electronic company delivers an expensive consignment to a newly established Hotel wherein 20% of the electronic appliances were defected and were voluntarily delivered. When the matter came to an adjudicating authority, it was decided in favor of the electronic company because the person rendering justice, the central administrator, got corrupted. Therefore, to resolve such complications, the concept of a multi-signature wallet was introduced that was collectively held by many parties. However, initially it did not include any dispute resolution clause, clearly drafted rules or an applicable law in case of a dispute. In most cases, the decisions were actually enforced immediately. Hence, it was a high time to shift from a centralized method to a decentralized method where everything works on the cloud and less human interference is involved.

The decentralized method sets a platform that governs cloud arbitration, i.e., it allows anyone to be appointed as an arbitrator.[225] A decentralized method is a form of "digital courts" that works with blockchain technology whose main goal is to crowd source the arbitrators and provide fair and equitable rulings.[226] It provides a platform to resolve the disputes of interpretation inherent to 'smart

[225] Aaron Wright & Primavera De Filippi 'Decentralized Blockchain Technology and the Rise of Lex Cryptographia' (2015) 1 SSRN 48,49.
[226]Ast, F., and Dimov, D. 'Is Kleros a fair dispute resolution system?' (18 Oct 2018) Kleros blog, available at: https://blog.kleros.io/is-kleros-a-fair-dispute-resolution-system/ accessed 14 Dec 2021.

contracts' by reducing the costs. This decentralized method has three key players in the market: Kleros, Jur, and Aragon.[227]

Kleros was founded by Federico Ast and Clement Lesage in 2017, it is the first decentralized platform to become operational and was built on Ethereum blockchain technology. It has been a platform where more than 500 disputes have been resolved as of November 2020 and generated around $123,000 as arbitration fees.[228]

Aragon was founded by Jorge Izquierdo and Luis Cuende in 2017 with an aim to provide software tools to create these decentralized organizations. It launched its decentralized court in November 2019 inspired by Klero's work.[229]

Jur was founded by Alessandro Palombo and G.D. Filippi in October 2017 through a "Societe commercial" under Swiss law and is more focused on enterprise use cases. This player includes three types of courts: the Open layer, the Community layer, and the Court layer.

This type of justice industry is still in its early days if we look at the statistics of May 2020 the market value of decentralized justice platforms was approx. $10 million and the users under one thousand

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[227] Kevin Werbach, Trust 'But Verify: Why the Blockchain Needs the Law' (2018) 33 BERKELEY TECH. L.J. 489, 496-97.
[228] Yann Aouidef 'Decentralized Justice: A Comparitive Analysis of Blockchain ODR Projects' (2021) Frontiers, available at: https://www.frontiersin.org/articles/10.3389/fbloc.2021.564551/full accessed 25 Dec 2021.
[229] Aragon Aragon association, available at: https://anj.aragon.org/ accessed at 3 Jan 2021.

whereas the world legal markets are worth more than one trillion dollars and the blockchain market at $1.5 billion.[230] Albeit there is a high expectation of an increase in the number of users on these platforms as it has various advantages of its own. As Richard Susskind said in an interview that "The legal industry will change more in the coming 20 years than in the previous 200."[231]

IV. CHALLENGES

With the advent of countless opportunities, blockchain justice also brings in issues and flaws which need to be dealt with. There are various problems such as legal challenges, challenges relating to the award, self-enforcement clauses, technological issues, compliance of laws and other general clauses. Blockchain will only be effective in the business world when we would be able to deal with such issues. Blockchain arbitration sounds just like a fancy word that has blockchain added to it but, in the pragmatic sense, it has various concerns.

People at large are still trying to understand the concept of blockchain and are not well versed with it. For example, everything is coded in technology and there is no space for oral rounds while the "Right to

[230] 'Blockchain Technology Market Size, Share, and Trends Analysis Report By Type, By Component, By Application, By Enterprise Size, By End Use, By Region, And Segment Forecasts' 2019–2025 Grand View Researcher, available at: https://www.grandviewresearch.com/industry-analysis/blockchain-technology-market accessed 8 Jan 2021.

[231] Oliver Duchense'Technology's Impact on the Legal Profession: An Interview with Richard Susskind—Part 1' (2018) Priorilegal, available at: https://www.priorilegal.com/blog/technologys-impact-on-the-legal-profession-an-interview-with-richard-susskind-part-1 accessed 10 Jan 2022.

be heard" is an integral part of any dispute resolution mechanism[232] and thus the system does not follow the principles of natural justice. A self-executing agreement may look attractive but software script executes only that part of the agreement which is clearly instructed and it is unable to execute and handle trivial matters.[233] There are various integral parts in the contract which cannot be encoded in contract; principles of faith, reasonableness and various other general clauses are essentials of a contract.[234] So, until there is an AI judge who possesses these human qualities to adjudicate matters, blockchain arbitration will not be able to perform according to laws and general principles of arbitration.[235]

Another concern that is the sole of an arbitration agreement is confidentiality. Albeit blockchain technology claims to have anonymity, at the same time it is free from the laws of the land and thus creates doubt about the confidentiality of parties.[236] There can be no third-party involvement in blockchain arbitration but, in case a

[232] See n3, above.

[233] Nick Szabo 'Formalizing and Securing Relationships on Public Networks' (1997) Semantic Scholars, available at: https://www.semanticscholar.org/paper/Formalizing-and-Securing-Relationships-on-Public-Szabo/5b4cf1e37954ccd1ca6b315986d45904f9d2f636 accessed 16 Dec 2021.

[234] Larry A DiMatteo and Cristina Poncibo 'Quandary of Smart Contracts and Remedies: The Role of Contract Law and Self-Help Remedies' (2018) 26(6) European Review of Private Law 805.

[235] Eric Tjong Tjin Tai, 'Force Majeure and Excuses in Smart Contracts' (2018) 26(6) European Review of Private Law 787.

[236] Claire Morel de Westgaver 'Cybersecurity In International Arbitration – A Necessity And An Opportunity For Arbitral Institutions' Kluwer Arbitration Blog October 6 2017, available at: http://arbitrationblog.kluwerarbitration.com/2017/10/06/cyber-security/ accessed 14 Dec 2021.

third party is involved in a certain way, there are no provisions regarding that. As it is said, technology always comes with risks and flaws and, irrespective of what any creator claims, there are always some flaws in it.

A. ISSUES IN THE ENFORCEABILITY OF AWARDS

With the opening of new aspects in the law, the self-enforceability of an arbitral award is a huge challenge. There is an existence of risk in the current recognition procedure of the blockchain, but even if blockchain technology successfully develops widely used self-executing arbitration and other contracts[237] it would still be not able to follow the values of public policy and safeguards given by the law.

The New York Convention on the Enforcement of Foreign Arbitral Awards of 1958 is the most prominent code on enforcing international arbitral awards with 166 contracting states to the Convention.[238] Blockchain technology cannot cope up with the various articles of the convention. Article II of the convention clearly states that arbitration agreement must be in written format and requires the signature of parties,[239] which is not possible in blockchain mode.

Furthermore, for example, if a self-executing award is passed for

[237] Philipp Hacker, Ioannis Lianos, Georgios Dimitropoulos and Stefan Eich 'Regulating Blockchain: Techno-Social and Legal Challenges – An Introduction'.
[238] David B. Hoppe, 'Chain Of Justice Or Broken Link?: Blockchain And Crypto Dispute Resolution' Mondaq 20 August 2021, available at: https://www.mondaq.com/unitedstates/fin-tech/1104020/chain-of-justice-or-broken-link-blockchain-and-crypto-dispute-resolution accessed 3 Jan 2022.
[239] Convention on the Recognition and Enforcement of Foreign Arbitral Awards (UNCITRAL New York Convention)art V (2)(b).

breach of a law, it may be denied recognition under article (v)(2)(b) of the New York convention.[240] However, now the agreement has been encoded in the contract and it would be possible for the blockchain to be in compliance with the award despite its incompatibility with the law and thus it would not violate the provisions of the Convention.[241]

The performance of blockchain is mainly restricted to the digital world whereas commercial contracts take place in the physical world. For instance, blockchain has no source of verification whether the external data provided to it is correct or incorrect. A system or computer simply accepts the data and applies it to determine the applicability of the smart contract.[242] So, if there is a data in correction in the system parties might suffer losses as well. Furthermore, while coding bugs are common phenomena that can cause issues. Thus, parties need to draw their rights and obligations in the smart contract according to a legally enforceable valid dispute mechanism.[243]

[240] EU law, case C-126/97, Eco Swiss China Time Ltd v Benetton International NV, ECLI:EU:C:1999:269.

[241] What is Blockchain Arbitration and can it replace the NY Convention? Arbitration Institute of the Stockholm Chamber of Commerce 17 June, available at: https://sccinstitute.com/about-the-scc/news/scc-forecasts/what-is-blockchain-arbitration-and-can-it-replace-the-ny-convention/ accessed 8 Dec 2021.

[242] Craig Tevendale and Charlie Morgan 'Blockchain and Smart Contracts: novel opportunities for improving efficiency in contract execution and dispute resolution' (2018) Herbert Smith Freehills, available at: https://www.herbertsmithfreehills.com/latest-thinking/blockchain-and-smart-contracts-big-challenges-and-efficiencies-ahead accessed 16 Dec 2021.

[243] 'Inside Arbitration Perspectives On Cross-Border Disputes' (2020) Herbert Smith Freehills, available at: https://hsfnotes.com/arbitration/2020/03/02/inside-arbitration-issue-9-perspectives-on-cross-border-disputes/ accessed 16 Dec 2021.

B. LEGAL ISSUES

To make a contract legally binding, enforceable, and immutable, it must follow the contract law of a certain territory, wherever it is executed. Furthermore, parties have to decide in case of any bug in the software, what will be the jurisdiction and who has the authority to hear and decide the matter.[244] If the parties are not able to comply with the legal provision in blockchain, this will lead to a complete conflict of law situation across the globe according to blockchain servers.

In the process of blockchain, the arbitration legality of AI robots is yet to be decided, as it would be appointed as an adjudicator in the matter.[245] Mere understanding of clauses between the parties and law does not ensure justice; a judge must be sound, reasonable and should have the capacity to understand the matter beyond that. Every state would need to allow and fix certain criterion for AI to be an adjudicator.

Another issue that strikes in the matter is the balance between the rights of creditor and debtor. As stated above, automation in enforcing contract seems difficult to reconcile with the balancing.[246] For instance, if there is a rental agreement between the parties and the tenant fails to pay the monthly rent on time, AI has the power to close the door which will result in the violation of the tenant's fundamental

[244] See 23, above.
[245] Adam Sanitt 'Blockchain dispute risks for banks', available at: https://www.nortonrosefulbright.com/en/knowledge/publications/3fb55e09/blockchain-dispute-risks-for-banks accessed 21 Dec 2021.
[246] Transnational systems of arbitration: Ralf Michaels. 'Dreaming law without a state: scholarship on autonomous international arbitration as utopian literature' (2020) 1(1) London Review of International Law 35.

rights,[247] which are of course of paramount importance. To prevent these kinds of violations state needs to create a regulatory body and laws to regulate the software.

Another issue which needs to be addressed is the venue of jurisdiction in case software is not able to resolve the problem and states will certainly bring up the issue of sovereignty in such cases. For these reasons to avoid excessive restraint and problems in technological evolutions, the government needs to draw certain guidelines on software regulations.

To conclude, the idea of blockchain arbitration has various issues which were identified but still, there is ample amount of opportunity in the area if states agree to cooperate and work together. Excessive restraint will only harm the idea of blockchain arbitration. The government needs to draft certain guidelines and identify a list of dos and don’ts for the coders to do.[248]

V. INDIAN OVERVIEW

India being a developing nation has great potential to accept blockchain and make a move in this technology. India is also

[247] Pietro Ortolani ‘The impact of blockchain technologies and smart contracts on dispute resolution: arbitration and court litigation at the crossroads’ (2019) Oxford Academic, available at: https://watermark.silverchair.com/unz017.pdf? accessed 6 Jan 2022.

[248] *This regulatory approach has already proved useful in the case of the 2004 IBA Guidelines on Conflict of Interest in International Arbitration, which contain different lists describing practical scenarios and attaching different types of consequences to them.*

accepting the various methods of ADR now and thus India can have a great opportunity in the field of blockchain arbitration.

However, certain legal and technical issues would arise with the implementation of blockchain technology, specifically if we start using the smart contract with on-chain blockchain technology. Although, the Indian government has taken steps to be at par with technology by mitigating all the technical issues through various rules and legislations.

A. ENFORCEABILITY OF AWARDS

One of the main issues in India is whether the award passed by such a process is allowed according to Indian laws and regulations as well as international law since the New York convention also does not consider these agreements valid.[249] However, Arbitration and Conciliation Act, 2015 was introduced to make the act at par with contemporary technical challenges, there is a lack of clarity. Section 7 of the Arbitration and Conciliation Act 1996 clearly states that for an agreement to be valid, it must be in writing.[250] Act of 2015 amends this provision and states that if an agreement is communicated through 'electronic means', it would be considered a valid agreement. But the meaning of the word 'electronic means' is yet to be defined.

[249] Sayanika Dey, Sneha Chatterjee 'Blockchain Arbitration and Smart Contracts In India' Nyayshastra law review, available at: https://hcommons.org/deposits/item/hc:38659/ accessed 3 Jan 2021.

[250] The Arbitration And Conciliation Act, 1996, available at: https://legislative.gov.in/sites/default/files/A1996-26.pdf.

However, section 10 of the Indian Contract Act,[251] which defines the essential ingredients to a contract fulfills the criterion of the smart contract.[252] Furthermore, Section 10A of the IT Act validates the contract which is made through electronic means. This provision defines electronic means as means used for the creation of an "electronic record".[253] Therefore, we can conclude smart contracts and blockchain agreements will be valid under section 7 of the Arbitration and Conciliation Act.

B. DETERMINING TERRITORY OF THE AWARDING COUNTRY

In blockchain arbitration, arbitrators are selected by the arbitration centers after the request of arbitration is made by smart contracts. However, while passing the judgment, copies of the award are distributed on different computers in different countries. However, the award does not have jurisdiction in any particular territory. This raises the issue of whether such awards are valid under Indian laws. India is a party to New York Convention and has a reciprocity reservation under Article I of the Convention[254] to determine which contracting states can pass the award and which will be binding in India. This no-country jurisdiction of blockchain arbitration is not valid under this

[251] The Indian Contract Act, 1872, available at: http://uputd.gov.in/site/writereaddata/siteContent/indian-contract-act-1872.pdf.
[252] Vijay Pal Dalmia 'Blockchain And Smart Contracts – Indian Legal Status' Mondaq (5 Feb 2020), available at: https://www.mondaq.com/india/fin-tech/889458/blockchain-and-smart-contracts-indian-legal-status accessed 15 Dec 2021.
[253] The Information Technology Act, 2000 (No. 21 OF 2000), available at: https://eprocure.gov.in/cppp/staterulesandprocs/kbadqkdlcswfjdelrquehwuxcfmijmuixngudufgbuubgubfugbububjxcgfvsbdihbgfGhdfgFHytyhRtMjk4NzY
[254] See 20, above.

principle.

C. EVIDENCE OF AWARD

Section 36 and 38 of the Arbitration Act requires certifies an original copy of the award.[255] The basic mechanism of blockchain makes it difficult to change anything in any document. Thus, this also needs various changes in order to go with blockchain.

The nature of blockchain also makes amendment in the contract almost impossible as it cannot be changed once it has become a contract and clauses from time to time needs various amendments. So, every time we amend the contract, the contract has to be made once again, which is an expensive, slow and hectic process.

VI. CONCLUSION

Under Blockchain Technology, the process, significance, and function of Smart Contracts are very clearly explained above. Whereas in India, the legal predicament of Smart Contracts is quite uncertain. For such uncertainty, there are two main explanations.

Many envisage that the blockchain framework would allow transactions to be carried out quickly and efficiently. Fast and cost-friendly arbitration is considered to be one of the potential advantages of this technology. The threats of the blockchain method, however, should be measured correctly. While blockchain technology offers attractive solutions in the current situation, it is not yet an alternative

[255] See n31, above.

to classical arbitration, mainly because of problems with compliance. Furthermore, the process's organizational and procedural dimensions are not completely determined and usable. Other issues about the process to be carried out through a blockchain are the relevant law and competence.[256]

The legal fraternity needs to be more open-minded and bias-free, while the tech community needs to maximize their potential and gain enough expertise in the field of arbitration and smart contracts- only then the difference can be covered. Since the outcomes of the detrimental cases cannot be anticipated, there is a need for a mechanism to resolve the disputes arising out of such smart contracts.[257] Especially, there needs to be a codified law that would be applicable in a particular jurisdiction. The preference of the parties should be to introduce an arbitral model including rules whereby an audit of the code with the underlying rules be made in order to ensure that the code is actually conforming with the rules prescribed.[258]

[256] 'The Blockchain Dispute Resolution Layer' KLEROS, available at: https://kleros.io/ accessed 9 Dec 2021.
[257] James Sower 'Sagewise Pioneers Dispute Resolution for Smart Contracts' ICO CROWD (July 21, 2018), available at: http://icocrowd.com/sagewise-pioneers-dispute-resolution-for-smart-contracts/.accessed 09 Dec 2020.
[258] JD Alois 'Sagewise Pitches Dispute Digital Resolution Protocol for Blockchain Based Smart Contracts' CROWDFUND INSIDER (Feb. 19, 2018), available at: https://www.crowdfundinsid.er.com/2018/02/128595-sag ewise-pitches-dispute-digital-resolution-protocol-blockchain-based-smart-contracts/ accessed 9th Dec 2020.

THE CONUNDRUM OF LIFTING THE CORPORATE VEIL OF ONE-PERSON COMPANIES FOR TAX EVASION

Sagnik Sarkar[259]

ABSTRACT

The Companies Act, 2013 has introduced the concept of One-Person Companies ('OPCs') in India for the first time. By definition, an OPC is a company which consists of a single member. The sole member of an OPC can also be its sole director. Classically, the 'Insubordinated Agency' Rule and the 'Business Purpose' Rule are used to determine when a company's corporate veil can be lifted for tax evasion. When these classical rules are applied to an OPC, absurd and unreasonable results follow. The corporate veil of an OPC becomes liable to be lifted far more than that of any other company. In some cases, this reduces the corporate personality of an OPC to a complete farce. Thus, the classical rules seem inadequate for OPCs. It is necessary to suitably modify, or discard, them. Lifting the corporate veil of an OPC for tax evasion engages with two competing public policy considerations: the value of limited liability vis-a-vis the benefit of revenue. Hence, the rules governing the lifting of the corporate veil must strike a proportionate balance between these competing interests. By this yardstick, I suggest a new legal framework to govern the lifting of an OPC's corporate veil for tax evasion. Firstly, the 'Insubordinated Agency' Rule, which reduces the corporate personality of an OPC a complete farce, should never be applied to

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an OPC. Secondly, the 'Business Purpose' Rule should be retained, but subject to an important qualification. Merely the fact that its sole member has gained no reasonable business advantage by incorporating the OPC, does not necessarily mean the OPC in question lacks a reasonable business purpose. Finally, the corporate veil of an OPC should be lifted for tax evasion only in exceptional circumstances which satisfy the test of necessity.

I. INTRODUCTION

The concept of a One-Person Company ('OPC') was introduced in India for the first time through the Companies Act, 2013. The Act allows a company consisting of only one member to be incorporated, which is known as an OPC.[260] The sole member of an OPC can be its sole director.[261] Thus, a complete identity between the member and the company is practically possible, although the OPC is a legal person separate from its member.

It is now well-established that the corporate veil of a company can be lifted in cases of tax evasion.[262] From 01 April 2021, non-resident Indians, in addition to Indian residents, are allowed to be the sole member of an OPC.[263] This is likely to increase the number of OPCs incorporated. Thus, a court may soon be faced with the prospect of lifting the corporate veil of an OPC. However, the unique status of an OPC as a separate legal person consisting of a sole member, creates unique problems in respect of lifting its corporate veil. The classical

[260] Companies Act 2013, s 2(62) & s 3(1).
[261] *Id*., s 149(1).
[262] Avtar Singh, *Company Law* (17th edn, EBC 2018) 17-19.
[263] Companies (Incorporation) Second Amendment Rules, 2021, r 2(I).

tests of lifting the corporate veil of a company for tax evasion, when applied to an OPC, produce absurd results. The object of this paper is to demonstrate these problems, and suggest modifications to these classical tests when applied to an OPC.

In Part II of this paper, I will explain the concept of, and the intention underlying the introduction of, OPCs in India. In Part III, I will demonstrate how applying the classical rules of law regarding the lifting of the corporate veil for tax evasion to OPCs produces absurd results. In Part IV, I will study the public policy considerations underlying the lifting of the corporate veil for tax evasion. Finally, in Part V, I will apply these public policy considerations, and suggest a new set of model rules to determine the cases in which the corporate veil of an OPC can be lifted on the ground of tax evasion.

II. THE CONTEXT: THE STATUS OF ONE-PERSON COMPANIES

A. INTRODUCTION

The corporate personality of a company is a deeming legal fiction—an abstraction of the law which views the company as a legal person separate from its member[s].[264] This is equally true for an OPC. It is, after all, a type of company.

Corporate personality has been one of the greatest enablers of trade

[264] *Salomon v A Salomon & Co Ltd* [1896] UKHL 1; *Prest v Petrodel Resources Ltd* [2013] UKSC 34.

and commerce in the history of the Anglo-Saxon legal tradition.[265] The allure of limited liability, which is an incident of corporate personality, has attracted even sole entrepreneurs.[266] Unfortunately for them, Company Law has classically required a company to be consisted of multiple persons.[267] To overcome this limitation, many persons adopted circuitous devices to incorporate companies which were OPCs in fact, although OPCs were technically not allowed by the law.[268] Some jurisdictions, such as the USA, accepted the outcome of these devices and thus effectively allowed OPCs to function.[269] Other jurisdictions, such as the UK, viewed them as illegitimate and therefore denied OPCs from being established.[270]

Company Law legislations across the world have now come to expressly recognize OPCs. The OPC, a company consisted of a sole member, is the solution of the law to these sole entrepreneurs' yearning for the protection of limited liability. OPCs allow sole entrepreneurs the benefit of corporate personality, while allowing them to retain the freedom of carrying on their business alone.

265 Ron Harris, 'A New Understanding of the History of Limited Liability: An Invitation for Theoretical Reframing' 2019 Harvard Law School Forum on Corporate Governance, available at: https://corpgov.law.harvard.edu/2019/08/29/a-new-understanding-of-the-history-of-limited-liability-an-invitation-for-theoretical-reframing/ accessed 23 November 2021; *London and Globe Finance Corporation Ltd, re* (1903) 1 Ch 728.
266 Warner Fuller, 'The Incorporated Individual: A Study of the One-Man Company' (1938) 51(8) Harvard Law Review 1373, 1374.
267 *Id.* 1375.
268 *Id.* 1374-76.
269 *Id.*
270 *Wallersteiner v Moir* [1974] 1 WLR 991 (CA).

B. THE LEGAL POSITION IN INDIA

Prior to the Companies Act, 2013, Indian Company Law did not recognize OPCs.[271] This was contrary to the established legal trend worldwide.[272]

The J.J. Irani Committee Report, in 2005, had recommended that Company Law should allow companies consisted of a sole member, that is OPCs, to be incorporated as private companies.[273] It had also recommended the relaxation of regulatory requirements, and a requirement to appoint only one director, for OPCs.[274]

It is important not to lose sight of the intention behind this recommendation, which was to allow the benefits of corporate personality to be enjoyed by entrepreneurs.[275] It is unreasonable to expect every entrepreneur to associate with other persons to carry on a business. Hence, the objective of OPCs is to allow sole entrepreneurs to enjoy the benefit of corporate personality.[276] Allowing the benefit of corporate personality to sole entrepreneurs has the potential to tap into their entrepreneurial spirit and utilize it for the advancement of

[271] Singh (n 3) CXLVI.
[272] Vatsala Singh, India: 'One Person Company – A Concept for New Age Business Ownership' (Mondaq, 28 November 2013), available at: https://www.mondaq.com/india/corporate-and-company-law/278154/one-person-company-a-concept-for-new-age-business-ownership accessed 24 November 2021; Fuller (n 7) 1373-74.
[273] Ministry of Corporate Affairs, *Report of the Expert Committee on Company Law* (Government of India 2005) 15.
[274] *Id.*
[275] *Id.*
[276] *Id.*

the economy.[277] Regulatory concessions are granted to OPCs to ensure that the sole entrepreneur can concentrate their energies on carrying on their business rather than meeting regulatory compliances.[278]

The recommendations of the J.J. Irani Committee on OPCs were evidently effectuated in the Companies Act, 2013. OPCs, consisting of a single member, are now allowed to be incorporated.[279] There are two features of an OPC that are relevant to this paper. First, like other companies, their liability can be any one of three types: limited by shares, limited by guarantee, or unlimited.[280] Second, an OPC must have at least one director, and may have up to fifteen directors.[281] Hence, it is very much possible for the sole member of the OPC to be its sole director.

III. THE ABSURDITY OF THE PRESENT POSITION OF LAW APPLIED TO ONE-PERSON COMPANIES

The corporate personality of a company is a deeming legal fiction. It is an abstraction of the law which views the company as a legal person separate from its member[s].[282] This is metaphorically referred to as the corporate veil. The direct incident of corporate personality is the limited liability of its members. The liability of its members is capped

[277] *Id.*
[278] *Id.*
[279] Companies Act 2013, s 3(1).
[280] *Id*., s 3(2).
[281] *Id.* s 149(1).
[282] *Salomon v A Salomon & Co Ltd* [1896] UKHL 1; *Prest v Petrodel Resources Ltd* [2013] UKSC 34; *Union Bank of India v Khader International Construction* (2001) 5 SCC 22; *State of Karnataka v J Jayalalitha* (2017) 6 SCC 263.

to the extent they have actually contributed, or have agreed to contribute, to the capital of the company.[283] Thus, the corporate personality of a company protects its members from unlimited personal liability for the conducts of the company.

Since corporate personality is a fiction of the law, the corporate veil signifies the law's willful ignorance of the fact that the company is really consisted of its members. Thus, in theory, courts can very well deliberately disregard the corporate personality of the company and hold a member personally liable for certain conducts. This is metaphorically known as the lifting of the corporate veil.[284]

A court can lift the corporate veil in any appropriate case in the exercise of its judicial discretion, even if it is not expressly authorized to do so by a statute.[285] Although those cases cannot be exhaustively enumerated, judicial precedents have established some instances in which it would be proper to lift the corporate veil of a company.[286] Two of these instances, in which the corporate veil of a company can be lifted for taxation-related reasons, are relevant to this paper.

Firstly, the corporate veil can be lifted when the company in question serves no reasonable business purpose. In many cases, the incorporation of a company has the effect of allowing a member to avoid the whole, or some part, of their tax liability. Not all instances

[283] Paul L. Davies and Sarah Worthington, *Gower's Principles of Modern Company Law* (9th edn, Sweet & Maxwell 2012) 39-42; *J H Rayner (Mincing Lane) Ltd v Department of Trade and Industry* [1990] 2 AC 418 (HL).
[284] Davis and Worthington (n 24) 214-216; Singh (n 3) 13-15.
[285] *TELCO Ltd v State of Bihar*, AIR 1965 SC 40.
[286] *Id.*; Singh (n 3) 15.

of tax avoidance are tax evasion— and out of these, only tax evasion is unlawful.[287] Tax avoidance amounts to tax evasion when, the transaction in question appears to have no reasonable business purpose besides the avoidance of tax liability.[288] In such cases, the Court can lift the corporate veil of the company and hold the member[s] indulging in tax evasion personally liable to meet their tax liability.[289] Thus, the crucial factor on which the question of whether a tax avoidant transaction amounts to tax evasion turns, is the determination of a reasonable business purpose of the company in question. To determine the existence of a reasonable business purpose, courts attempt to identify a business advantage gained by incorporating the company that would not have been otherwise available to its members.[290] For brevity, I am terming this the 'Business Purpose' Rule. Since the sole member is the only member of an OPC, it is quite difficult to identify the business advantage incorporating an OPC can give rise to, in comparison to the benefits the sole member could have obtained as an individual. Hence, if this test, in its present form, is mechanically applied to an OPC, the corporate veil of an OPC will be liable to be lifted more frequently than that of other companies. Thus, applying this rule makes OPCs comparatively unattractive as a business structure, relative to other companies and alternative business structures. This is opposed to the very purpose underlying the introduction of OPCs, which is to make

[287] *W T Ramsay v. IRC* [1981] UKHL 1; *McDowell & Co Ltd v. CTO* [1985] 3 SCR 791; *Vodafone International Holdings BV v. Union of India* (2012) 6 SCC 757.
[288] *Id.*; *W T Ramsay v. IRC* [1981] UKHL 1; *McDowell & Co Ltd v CTO* [1985] 3 SCR 791.
[289] *Dinshaw Maneckjee Petit, re,* AIR 1927 Bom 371; *Juggilal Kamlapat v. CIT* (1969) 2 SCC 376; *Vodafone International Holdings BV v. Union of India* (2012) 6 SCC 757.
[290] *Id.*

OPCs serve as a gateway for the corporatization of businesses.

Second, a company's corporate veil can be lifted when it is an agency with no functional autonomy. In some cases, a company is so insubordinated to the control of a member that it quite literally dances to the whims and fancies of that member. Practically, it does not function independently at all. In such cases, the corporate veil of that company can be lifted to hold the member controlling it personally liable, since the company really is the individual member conducting themselves from behind the corporate veil.[291] When this arrangement is used for the avoidance of tax liability, the member in question can be held personally liable to fulfil their tax liability in respect of the incomes of the company.[292] For brevity, the author terms this the 'Insubordinated Agency' Rule. If an OPC consists of a sole director who is also its sole member, then the OPC becomes completely insubordinated to the whims and fancies of the sole member. Hence, the corporate veil of an OPC with a single director will theoretically be liable to be lifted in every case.

Thus, when these classical tests are applied to an OPC, its corporate veil becomes more or less a farce. This is conspicuously opposed to the purpose of OPCs, which is to extend the benefits of corporate personality to sole entrepreneurs. Thus, the classical rules are inadequate to govern the lifting of the corporate veil of OPCs for tax

[291] *Wallersteiner v. Moir* [1974] 1 WLR 991 (CA); *Littlewoods Mail Order Stores Ltd v IRC* [1953] 1 WLR 483 (CA).
[292] *Id.*; *Apthorpe v. Peter Schoenhofen Brewing Co Ltd* [1899] 4 TC 41 (CA); *CIT v. Sri Meenakshi Mills Ltd* [1967] 1 SCR 934; *Furniss v. Dawson* (1984) AC 474 (HL); *McDowell & Co Ltd v. CTO* [1985] 3 SCR 791.

evasion.

IV. PUBLIC POLICY CONSIDERATIONS UNDERLYING THE LIFTING OF THE CORPORATE VEIL FOR TAX EVASION

Lifting the corporate veil of a company deprives its member[s] of the protection of limited liability and makes them personally liable for the conducts of the company. Hence, the lifting of the corporate veil of any company for tax evasion engages with two competing public policy considerations: the disadvantages and injuries consequent to discarding its limited liability; vis-a-vis the benefits of holding a member personally liable for using the company as an instrument for tax avoidance.

Due to limited liability, every member of the company is liable for the conduct of the company only to the extent they have contributed, or have agreed to contribute, to the company's capital. Thus, limited liability shields the members' personal assets from the fallouts of the company's conduct. Their risk is limited only to the extent of the capital they contribute to the company.[293] This central effect of limited liability forms the bulwark on which it can be defended on public policy grounds. Limited liability, by protecting the personal assets of the investor, reduces the risk of investment. Investors always prefer to minimize risk.[294] Hence, the protection of limited liability tends to incentivize persons to invest their surplus funds as capital

[293] Davis and Worthington (n 24) 207.
[294] N. Gregory Mankiw, *Principles of Economics* (7th edn, Cengage 2003) 542-543.

contributions to companies.[295] Companies can then utilize these funds to carry on more business. Therefore, everything else remaining constant, limited liability causes an increase of business. The promotion of business leads to a consequent increase of economic productivity. There is, globally and historically, a strong correlation between increasing economic productivity and improving standards of living.[296] Thus, there is a legitimate public interest in the promotion of business, and therefore the protection of limited liability.[297]

On the other hand, the very survival of a State, and its ability to discharge its welfare functions, is dependent on its revenues.[298] The proceeds of taxation are a substantial source of revenue for the government. In contemporary years, tax revenue consists about 80-85% of the Government of India's total revenues.[299] Hence, the State also has a legitimate public interest in raising revenue.[300] It is possible for a company to be incorporated merely to be used as an instrumentality to circumvent the tax liability of a member. In such cases, it is in public interest to lift the company's corporate veil and hold that member personally liable.

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295 *Id.* 207-12.
296 *Id.* 13.
297 *LIC v Escorts Ltd* (1986) 1 SCC 264; *Canada Enterprises Corp Ltd v MacNab Distilleries* [1987] 1 WLR 813 (CA).
298 *Juggilal Kamlapat v. CIT* (1969) 2 SCC 376.
299 Dilasha Seth, 'India's tax-GDP ratio plunges to 9.88% in FY20, lowest in 10 years' *Business Standard* (New Delhi, June 24 June 2020), available at: https://www.business-standard.com/article/economy-policy/india-s-tax-to-gdp-ratio-plunges-to-a-decade-low-of-9-88-in-fy20-120060801629_1.html accessed 24 November 2021.
300 *Dinshaw Maneckjee Petit, re,* AIR 1927 Bom 371; *Juggilal Kamlapat v. CIT* (1969) 2 SCC 376.

The State inevitably has to pursue multiple public interests simultaneously. Quite often, the pursuance of one public interest tends to derogate from another public interest. The lifting of the corporate veil for tax evasion is one such scenario. It benefits the revenue interests of the State while harming the public interest in protecting limited liability. The challenge is to balance these competing considerations. The pursuance of one public interest must not completely derogate from a competing public interest.[301] Whenever a State pursues a public interest which competes with another public interest, a proportionate balance must be struck between the two.[302]

Thus, the rules governing the lifting of the corporate veil of a company for tax evasion must strike a proportionate balance between these two competing public interests— the protection of limited liability, and the benefit of revenue.

V. SUGGESTED NEW FRAMEWORK

In Part III, I have demonstrated that the classical rules of lifting the corporate veil of a company for tax evasion, when applied to OPCs, produce absurd results. Thus, it is inappropriate to apply these rules, in their present form, to OPCs.

If the classical rules are applied to OPCs, it risks almost entirely sacrificing the limited liability of an OPC at the altar of the benefit of

[301] *R (Miller) v Prime Minister* [2019] UKSC 41.
[302] *Modern Dental College & Research Centre v. State of Madhya Pradesh* (2016) 7 SCC 353; *K S Puttaswamy v. Union of India* (2017) 10 SCC 1; *Anuradha Bhasin v. Union of India* (2020) 3 SCC 637.

revenue. To the contrary, if the corporate veil of an OPC cannot be lifted at all on the ground of tax evasion, it risks completely sacrificing the benefit of revenue at the altar of protecting the limited liability of an OPC. Logic dictates that a middle path is necessary. Hence, the challenge here is to identify the rules which should guide a court in determining this middle path— the cases when it is appropriate to lift the corporate veil of an OPC for tax evasion.

A. THE 'INSUBORDINATED AGENCY' RULE SHOULD BE DISCARDED

The first classical rule is the 'Insubordinated Agency' Rule. According to this rule, the test is to analyse if the company in question is so insubordinated to the control of a member that it quite literally dances to the whims and fancies of that member.[303] If this is true, the company ceases to function independently of the member. Rather, it effectively functions as an extension of that member, as it is completely under their control.[304] In such a case, its corporate veil can be lifted.[305]

A court cannot issue a direction which has the effect of derogating from the express words of a statute.[306] In Part III, I have demonstrated that if the courts were to lift the corporate veil of an OPC by applying the 'Insubordinated Agency' Test, the corporate veil of an OPC

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303 *Wallersteiner v. Moir* [1974] 1 WLR 991 (CA); *Littlewoods Mail Order Stores Ltd v. IRC* [1953] 1 WLR 483 (CA); *McDowell & Co Ltd v. CTO* [1985] 3 SCR 791.
304 *Id.*
305 *Id.*
306 *Union of India v. Association for Democratic Reforms*, AIR 2002 SC 2112; *J P Bansal v. State of Rajasthan*, AIR 2003 SC 1405; State of Jharkhand v. Govind Singh JT (2004) 10 SCC 349.

consisting of a sole member who is also its sole director would theoretically become liable to be lifted in every case. This position of law renders the OPC an illusory concept, a shadow without substance, for OPCs with the sole member as the sole director. The Companies Act, 2013 allows OPCs with a single director to be incorporated. Thus, to apply the 'Insubordinated Agency' Rule to OPCs with single directors would amount to derogating from the express words of the statute. Hence, courts should refrain from applying the 'Insubordinated Agency' Rule to OPCs with single directors.

If the sole member wants to retain exclusive control of the OPC, I cannot see any sound reason why they would appoint anyone director other than their own self. The sole member is perfectly entitled to appoint a single director. That is a much easier, and lawful, manner of retaining exclusive control over the OPC compared to appointing one, or more, dummy directors. Therefore, it is rational to appoint multiple directors only if the sole member intends to relinquish exclusive control of the OPC. The 'Insubordinated Agency' Rule, by its very nature, can apply only when the OPC is under the exclusive control of its sole member. Hence, practically, the 'Insubordinated Agency' Rule would effectively never be applicable to an OPC with multiple directors. Thus, my proposal, in effect, is that the 'Insubordinated Agency' Rule must never be applied to lift the corporate veil of any OPC.

B. THE 'BUSINESS PURPOSE' RULE SHOULD BE QUALIFIED

The other classical rule is the 'Business Purpose' Rule. It states that when a company has no reasonable business purpose but to mitigate the effect of a member's tax liability, its corporate veil can be lifted.

In Part III, I have demonstrated that this rule renders the corporate veil of an OPC liable to be lifted more frequently than that of any other company. This flies in the face of the purpose underlying the introduction of OPCs under Indian Company Law.

However, the 'Business Purpose' Rule does strike a fine balance between the competing public policy considerations underlying the lifting of the corporate veil— that is, the benefits arising out of the protection of limited liability vis-a-vis the benefits of revenue arising out of mitigating tax avoidance. The direct effect of the privilege of limited liability is the promotion of business. When a company has no reasonable business purpose, there is no business to be harmed in the first place. Hence, the competing public policy considerations arising out of the protection of limited liability disappear. In such cases, the corporate veil of the company can be safely lifted without worrying about its fallout on the conduct of business. Hence, the 'Business Purpose' Rule may be applied to OPCs. However, it must be qualified to ensure that an OPC is not liable to have its corporate veil lifted more often than that of other companies. To this end, I suggest the following qualifications to the 'Business Purpose' Rule when it is applied to OPCs.

There are two cases in which an OPC will conspicuously lack a reasonable business purpose. The first case is when the OPC is a shell company. A 'shell company' is a company which carries on no business of its own. Hence, if a 'Shell OPC' is used for tax avoidance, it will be an open-and-shut case in which the 'Business Purpose' Rule can be applied to lift its corporate veil. The second case is when the OPC is engaged in a business of a nature that no sensible person can conclude it has a reasonable business purpose. For this purpose, the standard of Wednesbury unreasonableness,[307] a concept ordinarily used in administrative law, can be analogously applied to determine the commercial reasonableness of an OPC's conduct. Under the *Wednesbury* principle, the decision of an administrative authority can be judicially reviewed if it is so unreasonable that no sensible person could have arrived at it.[308] Similarly, if the OPC is engaged in conducts so absurd that no sensible person can possibly regard it as having a reasonable business purpose, it must be regarded as having no reasonable business purpose. These two cases are open-and-shut cases in which an OPC clearly does not have any reasonable business purpose.

In all other cases, the question of whether an OPC has a reasonable business purpose must be determined from the particular facts and circumstances. However, this must be qualified by the crucial caveat. The 'business advantage' indicator, which is ordinarily the standard by which the existence of a reasonable business purpose is determined, should not be applied to OPCs. According to the 'business advantage' indicator, a reasonable business purpose exists when a business advantage is gained by incorporating the company that would not have been otherwise available to its member[s]. Even when an OPC is conducting itself with a legitimate business purpose, due to the complete identity between the company and its sole member, such a business advantage is quite difficult to attribute to the OPC. Hence, courts should not apply the 'business advantage' indicator to determine whether a reasonable business purpose can be attributed to an OPC. In other words, merely the fact that there is no business

[307] *Associated Provincial Picture Houses v. Wednesbury Corporation* [1948] 1 KB 223.
[308] *Id.*

advantage gained by incorporating the OPC that would not have been otherwise available to its sole member, does not necessarily mean that the OPC lacks a reasonable business purpose.

C. NECESSITY SHOULD BE AN ESSENTIAL CONDITION

In every case, the lifting of the corporate veil of an OPC must strike a proportionate balance between the competing public policy considerations in question— the value of limited liability, vis-a-vis the benefit of revenue. Inherent in this requirement of proportionality is the condition of necessity.[309] Necessity requires the least harmful means to be chosen in every case.[310] Thus, when there is a choice between two or more equally effective means, the one that causes the least harm must be chosen.

There are a variety of means available to fasten liability on a company for tax evasion. Lifting its corporate veil is only one of them. Lifting the corporate veil of a company is a drastic measure which causes significant harm.[311] It lies on the higher end of the scale of harm. Thus, the condition of necessity requires that the corporate veil of an OPC may be lifted for tax evasion only when, there is no other equally effective means of fastening liability on the company for tax

[309] *Huang v. Secretary of State for the Home Department* [2007] UKHL 11; *Modern Dental College & Research Centre v. State of Madhya Pradesh* (2016) 7 SCC 353; *K S Puttaswamy v. Union of India* (2017) 10 SCC 1; *Anuradha Bhasin v. Union of India* (2020) 3 SCC 637.

[310] *Huang v. Secretary of State for the Home Department* [2007] UKHL 11; *Modern Dental College & Research Centre v. State of Madhya Pradesh* (2016) 7 SCC 353.

[311] *LIC v. Escorts Ltd* (1986) 1 SCC 264; *Vodafone International Holdings BV v. Union of India* (2012) 6 SCC 757; *Prest v Petrodel Resources Ltd* [2013] UKSC 34.

evasion.[312] Therefore, lifting the corporate veil of an OPC for tax evasion should be confined to exceptional circumstances, as a measure of last resort after all other avenues for fastening liability have been exhausted.

VI. CONCLUSION

In India, OPCs are a somewhat recent innovation of the law. The objective behind the introduction of OPCs is to extend the benefits of corporate personality to sole entrepreneurs, while allowing them to retain exclusive control over their business. Thus, OPCs are intended to serve as a gateway for the increasing corporatization of businesses. If OPCs must achieve this object, the instances in which their corporate veil can be lifted on the ground of tax evasion must be clarified to ensure regulatory certainty.

According to the present rules of law, the corporate veil of a company can be lifted on the ground of tax evasion when: (i) the company is an agency completely insubordinated to a member; or (ii) the company has no reasonable business purpose and is only a vehicle for tax avoidance. These rules, when applied to OPCs, produce absurd results. The 'Insubordinated Agency' Rule theoretically renders the corporate veil of an OPC with a single director liable to be lifted in every case. It thus makes the very concept of an OPC illusory. The 'Business Purpose' Rule makes OPCs liable to have their corporate veil lifted more frequently than that of other companies. This makes OPCs less attractive business structures than other companies, defeating their purpose as a gateway to the corporatization of business.

[312] *Id.*

Hence, it is most inappropriate to apply these rules, in their present form, to OPCs.

Some modifications to these rules are therefore in order. Firstly, the 'Insubordinated Agency' Rule should never be applied to OPCs, as it renders the very concept of an OPC illusory. Secondly, the 'Business Purpose' Rule should be retained. It strikes a good balance between the conflicting public policy considerations in lifting the corporate veil of a company. However, it should be applied to OPCs with qualifications which mitigate the discriminatory, and prejudicial, treatment of OPCs (vis-a-vis other companies) under the present form of the rule. To this end, two important qualifications to the 'Business Purpose' Rule are necessary. There appear to be only two instances which are open-and-shut cases of the lack of a reasonable business purpose— the OPC is a shell company, and the OPC is engaged in conducts so absurd that no sensible person can possibly regard it as having a reasonable business purpose (Wednesbury unreasonableness). In all other cases, whether the OPC has a reasonable business purpose is a question of fact which must be determined holistically in the particular facts and circumstances of the case. However, merely the fact that there is no reasonable business advantage gained by incorporating the OPC that would not have been otherwise available to its sole member, does not necessarily mean that the OPC lacks a reasonable business purpose. Finally, the corporate veil of an OPC should be lifted only in exceptional circumstances that satisfy the test of necessity. Only those circumstances in which there is no other equally effective, and less harmful, means to fasten liability on the OPC for tax evasion, will be able to rise to this threshold.

It appears that no judicial authority in India has yet been faced with the prospect of deciding a case in which the corporate veil of an OPC has been sought to be lifted. It seems to be only a matter of time before some judicial authority will inevitably be confronted with the conundrum of lifting the corporate veil of an OPC for tax evasion. This paper is intended to serve as a starting point for its inquiry in such cases.

SOFTWARE INDUSTRY AND INDIAN COPYRIGHT LAW: THE CURIOUS CASE OF HUMAN INTELLECT

Ridhi Gupta[313]

ABSTRACT

Recently, the US Supreme Court ruled in favour of Google in the Google v. Oracle dispute, labelling Google's use of Oracle's Application Programming Interface (API) as 'fair use'. This decision has brought to light the loopholes that are prevalent in the present intellectual property rights safeguards for computer software. Not only does this bring to attention the subjective application of the fair use test by US in the instant case but also the problems prevalent in the Indian laws in this regard. This article is an attempt to highlight the lacunae present in the current copyright protection to computer programs in India. It tries to lay down some tests developed in the United States and suggests how India needs to explore these tests or come up with its own test that can be applied to subject matters like computer program, unlike the present established 'audience test'. The main purpose of this article is to highlight the need for a wholesome protection to computer software, which also falls within the ambit of "creations of the human intellect".

I. INTRODUCTION

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The software industry is one the fastest growing industries in the world. The Indian software product industry is expected to reach US $100 billion by 2025.[314] What comes along with these developments is the risk of piracy and duplication. Thus, the question of intellectual property rights comes into picture and the need to grant rights and protections to those who create and develop the products is felt. A software is a set of computer programmes that help the computer in functioning and executing tasks.[315] It is thus an "intellectual creation." However, the nature of a software is very different to any traditional good as it is 'intangible' and intrinsically related to complex computer related developments such as computer codes and algorithms.

Recently, the *Google LLC v. Oracle Private Ltd*[316] case garnered a lot of attention. The dispute between these two companies arose with Google's use of Oracle's Application Programming Interface (API) in its android software. API is a computer code that enables the transmission of data from one software to another.[317] Oracle sued Google for copyright and patent infringement, however, the US Supreme Court ruled in favour of Google, labelling its use as a "fair use".

[314] 'IT & BPM Industry in India' (*Indian Brand Equity Foundation*), available at: https://www.ibef.org/industry/information-technology-india.aspx accessed 25th November, 2021.

[315] Linda Rosencrance, 'Software' (*TechTarget*), available at: https://www.techtarget.com/searchapparchitecture/definition/software#:~:text=Software%20is%20a%20set%20of,that%20run%20on%20a%20device accessed 20th October, 2022.

[316] 576 US 1071 (2015).

[317] 'What is API : Definition, Types, Specifications, Documentation' (*Altexsoft, 28 July, 2021*), available at: https://www.altexsoft.com/blog/engineering/what-is-api-definition-types-specifications-documentation/ accessed on 25th November, 2021.

This article will try to focus on the status of computer software protection under the international arena vis-à-vis in India. Further, the article shall delve into the different tests developed in the United States to determine the copyrightability of software. Finally, the article shall provide a critical analysis of the Google judgement delivered by the US Supreme Court. The main purpose of this article shall be to highlight the need to protect computer related products in a more inclusive manner, by recognising the rights of its non-literal aspects as well so that they may not be made an exception to the definition of "intellectual property." They too fall well within the meaning of "creation of mind", as is required under intellectual property rights.

II. INTERNATIONAL LAW POSITION ON COMPUTER SOFTWARE

The Trade Related Aspects of Intellectual Property Rights (TRIPS)[318] is the most comprehensive multilateral agreement on intellectual property. This was the first international agreement to grant protection to computer software and it grants a twofold protection to computer software:

(i) Copyright
(ii) Patent

Article 10[319] of TRIPS lays that (1) "computer programs, whether in source or object code, shall be protected under the Berne Convention,

[318] The Trade Related Aspects of Intellectual Property Rights 1995.
[319] *Id.*, art. 10.

and (2) "compilations of data or other material, whether in machine or readable form, which by reason of the selection or arrangement of their contents constitute intellectual creations as such and such protection shall be without prejudice."

Article 27 (1)[320] provides that patents can be provided for, "any technology related inventions provided they are new, involve an inventive step and are capable of industrial application".

Article 39[321] of the agreement goes one step ahead to protect *trade secrets* within software. Some software may contain a lot of valuable and confidential information about a company which the company would want to keep as a "secret". The agreement extends protection to this software in case – (i) it is something which is not generally known by people working in the same field, (ii) it has commercial value and (iii) reasonable steps have been taken to keep it a secret.

The TRIPS agreement, thus, tries to provide a holistic safeguard for software developers.

[320] *Id.*, art. 27 cl. 1.
[321] *Id.*, art. 39.

III. THE INDIAN POSITION

A. PATENT LAW OR COPYRIGHT LAW : WHAT PROTECTS THE COMPUTER SOFTWARE?

In India, computer programs are copyrightable but not patentable. Under the Indian Copyright Act, 1957,[322] Section 2(o)[323] provides that "literary work includes computer programmes, tables and compilations including computer databases." Under Section 2 (ffc),[324] computer programme has been elaborated to mean "a set of instructions expressed in words, codes, schemes or in any other form, including a machine readable medium, capable of causing a computer to perform a particular task or achieve a particular result."

The Patent Amendment Act, 2002[325] explicitly excluded computer programmes from patentability in the Patent Act, 1970.[326] Section 3(k),[327] which was inserted by this amendment, provides that "a mathematical or business method or a computer mechanism per se or algorithms are not patentable." Thus, the position of law is very clear, computer software is a subject matter of copyright but not patent.

B. LACUNAE IN THE LAW

Though, the Copyright Act protects computer software, there are mainly twofold concerns that undermine this protection. These are: (i)

322 The Indian Copyright Act 1957, Act No. 14 of 1957.
323 *Id*., § 2 cl. o.
324 *Id*., § cl. ffc.
325 The Patents (Amendment) Act 2002, Act No. 38 of 2002.
326 The Patents Act 1970, Act No. 39 of 1970.
327 *Id*., § 3 cl. k.

the requirement of a material form or expression and (ii) the wide possibility of misusing the fair dealing and reverse engineering provisions provided under the law.

1. THE REQUIREMENT OF A MATERIAL FORM

In order to get protection under the Copyright Act, it is essential that the subject matter is expressed in some *material form* that is in writing or print or in some form of notations or symbols, which means in a form capable of either visually or audibly recreating the representation of the original work.[328] This means that in order to get protection under the law some expression is required. The ideas that help in the creation of the computer software are not protected under the law. This is problematic because these ideas hold significant commercial value for the creator. It may happen that before a person is able to materialise his/ her idea, another person can copy such an idea and develop on it.

For instance, algorithms which are well defined instructions to aid in completion of the tasks remain unprotected by the copyright law. These instructions are the comprehensive step that lay down the essential steps for information processing by the computer and also the order in which such steps should be followed. As these algorithms do not form a part of the object or the source code (as they help in

[328] SK Verma, 'IP Protection of Software and Software Contracts in India: A Legal Quagmire!' (2012) 17 Journal of Intellectual Property Rights, available at: https://core.ac.uk/display/297955366 accessed on 26th November, 2021.

their creation itself) these remain as mere "ideas" and are unconsidered by law.[329]

2. FAIR DEALING AND REVERSE ENGINEERING

Under Section 52[330] of the Copyright Act, fair dealing and reverse engineering are provided. Just as the fair use test in the United States provides for certain exceptions where use of a copyright work shall not constitute an infringement, similarly in case of common law countries the equivalent test is the fair dealing test. In relation to a computer software, the following acts are not considered as infringement –

Section 52(aa)[331] allows the making of copies or adaptation of a computer programme by the lawful possessor of a copy of such computer programme, from such copy –

(i) in order to utilise the computer programme for the purpose for which it was supplied.
(ii) to make back-up copies purely as a temporary protection against loss, destruction or damage in order only to utilise the computer programme for the purpose for which it was supplied.

[329] Sankalp Jain, 'Legal Protection of Computer Software in India' (2014) SSRN, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2462269 accessed on 26th November, 2021.
[330] § 52, Indian Copyright Act 1957.
[331] § 52 cl. aa, Indian Copyright Act 1957.

Sections 52(ab)[332] and 52(ad)[333] provide for what can be called as Reverse engineering. Reverse engineering is the process of analysing an existing product in detail in order to manufacturer a similar product.[334]

Section 52(ab) provides "the doing of any act necessary to obtain information essential for operating inter-operability of an independently created computer programme with other programmes by a lawful possessor of a computer programme provided that such information is not otherwise readily available." While Section 52(ad) provides "the making of copies or adaptation of the computer programme from a personally legally obtained copy for non-commercial personal use". Though these provisions were added to avoid monopolisation of software, there exist no instructions regarding the manner in which such uses will be checked which can result in making the protection for software futile.[335]

Further, Section 52 (ac)[336] allows "the observation, study or test of functioning of the computer programme in order to determine the ideas and principles which underline any elements of the programme while performing such acts necessary for the functions for which the computer programme was supplied." This provision can grant access of the computer software even to the competitors, who can get to know

[332] Indian Copyright Act 1957, § 52 cl. ab.
[333] *Id*., § 52 cl. ad.
[334] 'Reverse engineer' (*Merriam webster*), available at: https://www.merriam-webster.com/dictionary/reverse%20engineer accessed on 26th November, 2021.
[335] Ameen Datta & Suvarna Mandal, 'Reverse engineering and India's Copyright Act' (2015) Indian Business Law Journal, available at: https://law.asia/reverse-engineering-and-indias-copyright-act/ accessed on 26th November, 2021.
[336] § 52 cl. ac, Indian Copyright Act 1957.

about all the ideas and principles that were used by the copyrighted computer programme company. These competitors can, thus, come up with a more advanced version by delving into these ideas and principles. This provision, in the absence of any instructions or regulations to regulate the same, leaves the copyrighted programmes vulnerable at the hands of their competitors.

IV. THE TESTS DEVELOPED IN UNITED STATES

The United States has developed several tests to determine whether a software should be protected under the copyright act.

A. THE "LOOK AND FEEL" TEST

The first test is "the look and feel test". This phrase was used to mean all the *non-literal elements* of a computer program. The look of the program includes its demonstrative audio-visual elements – its screen displays, visible portions of the user interface and other visual and aural elements of output produced by the program. The "feel" of a program includes the dynamic, operational flow of the program, its keystrokes and other means for invoking functions, and the general recognizable "style" of operation the program presents to the user. In many instances, the "look" and "feel" categories overlap.[337]

B. THE STRUCTURE, SEQUENCE & ORGANISATION TEST

[337] David L. Hayes, 'A Comprehensive Current Analysis of Software "Look and Feel" Test', available at: https://assets.fenwick.com/legacy/FenwickDocuments/Look_-_Feel.pdf accessed on 26th November 2021.

In the case of *Whelan Associates Inc v. Jaslow Dental Laboratory Inc., 1986,*[338] the question that arose before the US Court of Appeal was that whether copying of the overall structure of a program results in copyright infringement or not. Though neither the object code nor the source code was copied in this present case, the Court held that the overall structure of a program comes within the "expression of idea" and thus, copying of the same would lead to copyright infringement. The Court observed an important aspect of an inclusive protection that needs to extend not only to the literal aspect of a computer program but also the non-literal elements by holding that "a copyright cannot be limited literally to the text, else a plagiarist would escape by making immaterial variations." Further, the Court held that "developing the structure and logic behind a computer program" are one of the most significant costs that have to be incurred in creation of a computer software.[339]

C. THE ABSTRACTION-FILTRATION-COMPARISON

In the case of *Computer Associates v. Altai, 1992*,[340] the Second Circuit US Court held that infringement of copyright in computer programs is shown by a substantial similarity of protectable expression, not just an overall similarity between the works. Thus, before evaluating substantial similarity, it is necessary to eliminate from consideration those elements of a program that are not protected by copyrights. In order to perform this evaluation, the Court in this

[338] 1986, 479 US 1031 (1987).
[339] Shyam Sunder Mahapatra, 'An Introduction to Intellectual Property Rights' (*Manupatra*), available at: http://www.manupatra.com/roundup/340/Articles/An%20Introduction%20to%20IPR.pdf accessed on 26th November, 2021.
[340] 1992, 982 F.2d 693.

case developed a three-stage test to determine whether or not there has been an infringement of copyright. The stages include :

1. ABSTRACTION

The first stage is 'abstraction', by which the non-literal elements of the program are determined by a process like reverse engineering, tracing back the programmer's steps in the process of writing the program. This operation results in the identification of the non-literal elements of varying degrees of detail.

2. FILTRATION

The second stage is one of filtration which includes, filtering out the elements that are not protected by copyright. For instance, if a certain idea can be expressed only in a single way, then such an expression cannot be copyrighted.

3. COMPARISON

The third stage is one of comparison. The elements present in this 'golden nugget' are at this stage compared with the defendant's program and in case of similarity between the two a holding of substantial similarity against the defendant is justified.[341]

[341] Yashojit Mitra, 'Copyright Protection of Indirect Copying of Computer Programs : Suggestions for Indian Courts' (2002) 8 Journal of Intellectual Property Rights, available at: http://docs.manupatra.in/newsline/articles/Upload/893B5967-8DA4-4AF4-854D-EB36A31AA388.pdf accessed on 28th November, 2021.

V. THE OPINION TEST IN INDIA

In India, what seems to be followed is the audience test or the opinion test to determine the existence or non-existence of copyright infringement. In the case of *R.G. Anand v. M/s Delux Films, 1978,*[342] the appellant believed that his play "Hum Hindustani" was being copied by the respondent's film "New Delhi". The appellant took legal recourse but both the trial court as well as the high court rejected the infringement plea. The matter reached the Supreme Court which held that the surest and safest test to determine whether or not there has been a violation of copyright is to see whether a spectator or viewer after having read or seen both the works is clearly of the opinion that the subsequent work appears to be a copy of the original. The Court came to this decision after considering a number of English, American and Indian authorities.

However, such a test cannot be applied to subject matters such as computer programs. Indian Courts have failed to consider the legal implications arising from copyright infringement of computer programs. The 'audience test' facially is inapplicable on computer programs, as it is meaningless to attempt to isolate the 'spontaneous and immediate reaction' of the lay observer to two sets of object code.[343]

[342] 1978, AIR 1978 SC 1613.
[343] Yashojit Mitra, 'Copyright Protection of Indirect Copying of Computer Programs : Suggestions for Indian Courts' (2002) 8 Journal of Intellectual Property Rights, available at: http://docs.manupatra.in/newsline/articles/Upload/893B5967-8DA4-4AF4-854D-EB36A31AA388.pdf.

VI. THE DECISION IN GOOGLE V. ORACLE : A CRITIQUE

The US Supreme Court declared the use of Oracle's API by Google a fair use. However, this seems to be in contrast to the provisions given under this test. The fair use test, which is given under Section 107[344] of the US Law, involves four factors :

(i) the purpose and character of the use, including whether such use is of a commercial nature or is for non-profit educational purposes;
(ii) the nature of the copyrighted work;
(iii) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and
(iv) the effect of the use upon the potential market for or value of the copyrighted work.

The first provision provides that the use must not be commercial in nature. However, in this case Google used Oracle's code to use this code for its android devices. This was a commercial purpose and not a non-profit purpose. *Secondly*, Google copied 11,500 lines of Oracle's API code which constitutes a significant amount in sense of a computer program. *Finally*, the effect on the market has been significant as the world sees a huge number of android users today. In his minority opinion, Judge Thomas, highlighted the fact that the majority is ignoring the damage caused to Oracle due to Google's actions.[345] For instance, evidence suggested that as a direct result of

[344] U.S. Code, Title 17, § 107.
[345] 576 US 1071 (2015).

Google's act, Amazon renegotiated a license fee with Oracle with a 97.5% reduction in royalty rate. Similarly, evidence of Samsung reducing its royalties to Oracle from $ 40 million to $ 1 million was also recorded. Thus, it is dubious why the Court decided to label this use as fair use. The minority opinion also criticised the majority's position of considering a declaring code to a lower copyright protection, as the statute considers all computer programs as one group and does not differentiate in the threshold or level of protection.[346]

VII. CONCLUSION

While the Indian law provides copyright protection to computer programs, it has failed to address the grey areas prevalent for misuse and copyright infringement in the name of fair dealing, reverse engineering or allowing the observation of the principles and ideas that result in the creation of a particular program. Further, the law does not provide protection to the non-literal aspects of a computer program, like algorithms, which leaves scope for such information to be missed by third persons. The Abstraction – Filtration – Comparison Test, developed in the US can act as a safeguard for the non-literal aspects of a computer program. Through this three-step test those non-literal aspects of a computer program can be determined, filtered out and then compared with the alleged infringed work. This would enable these non-literal parts in getting protection, which seems imperative

[346] Adarsh Ramanujan, 'SCOTUS Decision in Google v. Oracle: Distorting "fair use" but the scathing and logical dissent is the One Saving Grace' (*SpicyIp*, 7th April, 2021), available at: https://spicyip.com/2021/04/scotuss-decision-in-google-v-oracle-distorting-fair-use-but-the-scathing-and-logical-dissent-is-the-one-saving-grace-part-ii.html accessed on 28th November, 2021.

as they too are creations of human intellect and result in a wholesome protection to computer programs. However, there are two main issues that may arise if this test is incorporated in India:

(i) it would make the process very time taking and the aggrieved copyright holder may have to suffer undue legal costs and burdens; *and*

(ii) judges alone would not be able to implement this test in practice and would require aid from computer experts.

Despite these problems, it is essential that India either explores this test or creates a novel test that helps in safeguarding the rights of computer programmers, as the present "audience test" cannot be applied to such a subject matter. Further, even decisions like the one given in the case of *Google v. Oracle* should not be a precedent for similar future cases as even though Google's case failed the fair use test, the decision of the Court lied in its favour. Such decisions, if repeated, would not only result in the infringement of the rights of companies like Oracle but also hinder innovation and novel creations of the human mind.

BUILDING HIDDEN OWNERSHIP THROUGH EQUITY DERIVATIVES: THE LACUNAE IN INDIA'S TAKEOVER REGULATIONS

Anchit Nayyar[347]

ABSTRACT

*Regulation 29 of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations ("**Takeover Regulations**"), 2011 impose various disclosure obligations upon an acquirer when his shareholding in a public target company crosses a specified threshold of 5%.[348] While the intent behind such norms is to prevent market manipulation, as well as to give adequate warning signs to the target company's management in the build-up to a potential takeover,[349] corporate acquirers have often found creative ways and financial instruments to circumvent such obligations. One such instrument that has often been used successfully in the 21st century are Equity Backed Derivatives, which give the acquirer exposure to the target company's shares without actually owning them.[350] These essentially refer to securities/financial instruments whose value is derived from the value of an underlying equity instrument.[351] The present paper seeks to*

[347] The author is an Associate at AZB & Partners.
[348] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Regulation 29.
[349] Takeovers Regulations Advisory Committee, *Report of the Takeovers Regulations Advisory Committee,* ¶2.3 (July 19, 2010).
[350] Wolf-George Ringe, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk And Corporate Governance* 65-66 (Oxford University Press 2016).
[351] available at: https://www.nseindia.com/products-services/about-equity-derivatives.

*analyze whether the disclosure norms under Indian Takeover Regulations are sufficient to address sophisticated financial instruments such as Equity Backed Derivatives. The article commences by providing a brief overview about Equity Backed Derivatives, as well as the common market practices in its dealings. It then proceeds to analyze whether such derivatives would trigger disclosure norms under the Takeover Regulations. It further analyzes how disclosure related questions arising from such securities have been handled across jurisdictions such as USA, UK, EU, etc., arguing that the Takeover Regulations in India need to be amended along global trends to equip regulators like the Securities and Exchange Board of India ("**SEBI**") to handle volatilities and other adverse impacts that may arise from non-disclosure of material economic interests in securities, while also ensuring that such disclosures do not lead to an 'overflow' of information in the securities market.*

I. WHAT ARE EQUITY BACKED DERIVATIVES?

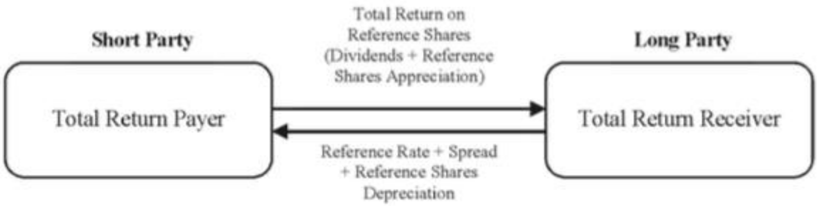
In 2008, Porsche SE, which was planning to take control over Volkswagen AG, disclosed upon a request from the German Stock Exchange that in addition to holding 42% shares in the company, it also held 30% economic exposure over Volkswagen's shares through cash settled options (derivative instruments settled in cash at the end of the transaction), which it was subsequently planning on amending to physically settled options (derivative instruments settled by transfer of the underlying equity shares). Thus, this meant that Volkswagen was able to change the arrangement from a contract for mere economic exposure to Porsche's shares to a contract for acquisition, while effectively blocking a sizable portion of Porsche's share capital from the securities market without having to make any disclosures to the markets for the entire duration of the contract. Needless to say, the disclosure led to high volatility in the market, briefly making Volkswagen the most expensive share in the world.[352] This also brought about the question as to how Porsche was able to avoid these vital disclosures under the takeover laws, which led to events that were specifically sought to be avoided by the takeover legislations across the world.

"Derivatives" have been defined in the Securities Contracts (Regulation) Act, 1957 as securities which derive their value from an underlying asset such as a debt instrument, share, loan etc.[353] Derivatives that use equity shares of a company as the underlying reference asset for the security are known as equity backed derivatives.[354] The party selling or writing the derivative is known as the 'short party', and generally bets against the share, while the party buying the derivative is known as the 'long party', and generally is the one betting on the share.[355]

While equity backed derivatives can take many forms, the most commonly used derivative from a takeover perspective Total Return Swaps ("**TRS**"). TRS is an agreement whereby the parties agree to exchange the notional incomes arising out of the referenced security

[352] Pierre Henri Conac, "Cash Settled Derivatives as a Takeover Instrument and the Reform of the EU Transparency Directive" (2007) The EUR. FIN. MARKET IN TRANSITION 49,51.
[353] Securities Contracts Regulation Act, 1957, Section 2(ac).
[354] 'Basics of Equity Derivatives', (Bombay Stock Exchange Ltd.), available at: https://www.bseindia.com/downloads/Training/file/BCDE.pdf.
[355] *Id.*

to each other.[356] Thus, in case of TRS referencing shares, the long party will be entitled to any increase in the value of the share price, as well as any dividends and other income arising out of it, whereas the short party would be compensated for any downfall in the share price.[357] The long party thus assumed total economic exposure to the referenced share without actually owning the share. The flow of incomes in a TRS can be explained as below:



These derivatives, upon termination, can either be settled in cash (wherein the parties settle the difference in share prices through cash) or in kind (wherein the long party delivers the referenced share to the short party).[358] If the TRS is to be settled in kind, the short party would have an obligation to purchase the referenced share, whereas if the TRS is to be settled in cash, no such purchase and sale obligation exists.

[356] Daniel Stankovic, "Challenges in the Takeover Early Warning System in the EU: The Case of Germany", (2014) 10 CYELP 291, 299-300.
[357] Department of Banking Operations and Development, Reserve Bank of India, *Report of the Working Group on Introduction of Credit Derivatives in India*, ¶2.5(b) (March 26, 2003).
[358] *Id.*

Firstly, even though the short party is not obligated to purchase the reference shares in cash settled derivatives transactions, in most cases the short parties do hold on to such shares to hedge their positions. This is because, if the share appreciates in value, the profits they make from physically holding the shares (and thereupon selling it in the open market) is sufficient to cover the cash payments they would have to make to the long party, whereas if the share price depreciates, the payments to be made by the long party under the transaction would act as an insurance cover for the short party.[359]

Secondly, while no obligation exists on the long party to sell off the reference shares upon termination of the TRS, most long parties do sell the shares to avoid the risk of equity depreciation once the downside protection in form of the equity derivative is gone.[360] This is exacerbated by the fact that the long parties in most derivate transactions tend to be banking institutions, who inherently tend to be risk averse, and thus have no use for the reference share post the transaction.[361]

Finally, when the TRS is about to expire, the long party, if it so desires, can simply ask the bank to amend the transaction from a cash settled to a kind settled derivative transaction. The banks seldom refuse to do the same, since refusing to sell the shares to the long party could mean compromising on a profitable business relationship.[362] In fact, the UK

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[359] *Glencore International v. Takeovers Panel*, [2006] FCA 274.

[360] Guido Ferranini, "Equity Derivatives and Transparency: When Should Substance Prevail", (2010) FESTCHRIST FUR KLAUS J HOPT. 1813, 1808-1822.

[361] Stankovic (n 8) at 304.

[362] Euginio De Nardis and Matteo Tonello, 'Know Your Shareholders: The Use of Cash-Settled Equity Derivatives to Hide Corporate Ownership Interests' (Cleary Gottlieb Steen & Hamilton LLP,July 2010), available at:

Committee on Takeovers and Mergers noted that it is most often the expectation of the long party that the derivative dealer would ensure the sale of the referenced share to him upon termination of the contract.[363]

Thus, even though cash settled equity derivatives do not legally provide ownership of the reference shares to the long party, the commercial practices in the derivatives industry ensure that the referenced shares are locked in for the period of the transaction in favour of the long party, without vesting any legal ownership rights with them.

II. CAN EQUITY DERIVATIVES FACILITATE HIDDEN OWNERSHIP: THE INDIAN LEGISLATIVE FRAMEWORK

The Takeover Regulations impose an obligation on the acquirer to disclose his shareholdings in a public company if the same, coupled with those held by Persons Acting in Concert **with him** crosses the 5% threshold.[364] A 'share' has been defined in the Takeover Regulations as shares in the equity capital of the target company carrying voting rights, and includes any security entitling the holder to exercise voting rights.[365] Further, for the purposes of disclosure

https://www.clearygottlieb.com/~/media/organize-archive/cgsh/files/publication-pdfs/know-your-shareholders-the-use-of-cash-settled-equity-derivatives-to-hide-corporate-ownership-interests.pdf.

[363] Panel on Takeovers and Mergers, *Outline Proposals Relating to Amendments Proposed to be Made to The Takeover Code and the SARS*, (January 7, 2005).

[364] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Regulation 29.

[365] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Regulation 2(1)(v).

norms, convertible securities, i.e., a security convertible or exchangeable with equity shares of the target company,[366] are also to be treated as shares in the target company.[367]

As mentioned earlier, if an equity backed derivative is to be settled in kind, the long party would have an obligation to purchase the referenced share, and, subsequently, sell the same to the short party.[368] Thus, given that the long party would be entitled to acquire the reference share upon termination of the contract, Equity Backed Derivatives settled in kind can be categorized as convertible securities, and are thus covered within the disclosure norms under the Takeover Regulations.

When it comes to cash settled equity derivatives, the issue is *res integra*. The author, however, argues that the derivative transaction, even if it is entered into with the long party's expectation and subsequent success in acquiring the references shares, would not be caught by the disclosure norms till the shares are ultimately acquired. This is because of the following reasons:

A. CASH SETTLED EQUITY DERIVATIVES CANNOT BE EQUATED WITH HOLDING SHARES IN THE TARGET COMPANY

As mentioned earlier, the Takeover Regulations define share as shares in the equity capital of the target company carrying voting rights, or

[366] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Regulation 2(f).
[367] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Regulation 28(2).
[368] Stankovic (n 8) at 301.

securities entitling use of such voting rights,[369] while a convertible security requires an entitlement with the acquirer to ultimately acquire the shares of the target company.[370]

In cash settled equity derivatives, in the absence of an agreement entitling the long party to control or direct the use of voting rights associated with a share, the derivative in itself cannot be equated with a share as under the Takeover Regulations.[371] Further, irrespective of the common market practices, cash settled derivatives like TRSs do not give the long party a legal right to acquire the same, thus not falling within the category of a convertible security either. Holding equity derivatives thus cannot be equated with the long party directly holding shares in the target company.

Even the Report of the SEBI appointed Takeovers Regulations Advisory Committee explicitly noted that physically settled equity derivatives would be within the ambit of the disclosure norms,[372] and despite noting the presence of cash settled derivatives in the Indian securities market, explicitly omitted any such reference to them in its notes on disclosure requirements. A comparison with the draft regulations[373] framed by the Committee would show that the same

[369] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Regulation 2(1)(v).
[370] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Regulation 2(1)(f).
[371] *The Childrens Investment Fund (UK) LLP et. al. v. CSX Corporation et. al.*, 654 F.3d 276; Supra Note 2 at 68.
[372] Takeovers Regulation Advisory Committee (n 2) at ¶16.4.
[373] Takeovers Regulation Advisory Committee (n 2) at Draft Regulations.

interpretation has also been incorporated in the Takeover Regulations.[374]

B. SHORT PARTIES IN CASH SETTLED DERIVATIVE TRANSACTIONS CANNOT IPSO FACTO BE DECLARED AS PERSONS ACTING IN CONCERT WITH THE LONG PARTY

As mentioned earlier, the Takeover Regulations not only require disclosure when the acquirer himself acquires shares, but also when Persons Acting in Concert ("**PACs**") with him cross the acquisition threshold of 5%. PACs have been defined in the Takeover Regulations as persons who

- with a common objective of acquisition of shares;
- pursuant to an agreement or understanding;
- directly or indirectly cooperate with each other for acquisition of shares in the Target Company.[375]

Thus, for two or more persons to be held to be PACs, it must be shown that both parties entered into the transaction with a common intent of acquiring shares beyond the specified threshold in the target company.[376] Thus, even if the long party to the transaction entered into the transaction with the object of acquiring shares beyond the specified threshold, unless the same is communicated to the short

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[374] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Regulation 29.
[375] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Regulation 2(1)(q).
[376] *Daiichi Sankyo v. Jayaram Chigurupati,* AIR 2010 SC 3089 ; *KK Modi v. Securities Appellate Tribunal*, [2003] 113 CompCas 418 (Bom); Sridharan & Pandian, *Guide To Takeovers & Mergers* 765 (4th ed., Lexis Nexis 2019).

party, the requirement of common object would not be met.[377] The long party could simply rely on the common commercial practices governing the derivatives industry as discussed above, without informing the other about their intent.

Further, the long party could also enter into derivative transactions with multiple short parties to keep their combined shareholding below the disclosure threshold to alleviate concerns that the regulator could fine them if they are found to be PACs. In such a situation, unless the respective short parties are made aware of all the TRS agreements the long party has entered into, the respective short parties would not be held to be PACs with each other, even if the long party is held to be a PAC with them. For instance, when Schaeffer, a German industrial group, launched a successful hostile takeover of Continental AG, a German listed company, it entered into multiple cash settled TRSs with various short parties such that its own shareholding coupled with any one of the short party would be below the 5% threshold, even though its combined shareholding with all the short parties was in excess of 30%.[378]

Thus, in the author's opinion, while corporate acquirers may very well enter into financial transactions like equity backed derivatives with the intent, and subsequent success in acquiring shares in the target company, they would be shielded from the disclosure requirements as meted out under the Takeover Regulations.

[377] *The Childrens Investment Fund (UK) LLP et. al. v. CSX Corporation et. al.*, 654 F.3d 276; *Ithaca Custodians v. Perry Corporation*, [2003] 2 N.Z.L.R 216 (H.C).
[378] Henri Conac (n 3) at 54.

III. PROBLEMS ASSOCIATED WITH CIRCUMVENTION OF DISCLOSURE NORMS UNDER THE TAKEOVER REGULATIONS

At the outset, it must be noted that Equity Backed Derivatives can serve a host of legitimate economic interests. For instance, it serves as an instrument to enable investors to reap the rewards of an uptick in the reference shares even if they do not have sufficient capital to invest in the target company. It essentially lets the investors take shares of a particular company on rent, while enabling short parties to reap income from it without any material equity risk.[379]

However, when such derivatives are used as sham transactions to evade disclosure requirements, with a prior understanding that they would acquire the shares in the end, it can lead to the following adverse events:

- *Firstly*, it enables the long party to keep an artificially depressed price for the reference share by taking out a large portion of the shares from the market circulation, and also by delaying information about a potential acquisition of the company.[380] It must be kept in mind that the announcement of a potential acquisition of a public company is often followed by a rally in its share price.[381] This thus means that in

[379]Reserve Bank of India (n 9) at ¶2.5(b).
[380] *Glencore International v. Takeovers Panel*, [2006] FCA 274.
[381] Radu Ciabano, Elena Tilica & Dragos Oprea, The Impact of M&A Announcements on Stock Price, 7th International Conference on Accounting and Information Management Systems' at 767, (Research Gate), available at: https://www.researchgate.net/publication/256496456_THE_IMPACT_OF_MA_ANNOUNCEMENTS_ON_STOCK_PRICES.

the time period where the long party (a potential acquirer) has locked shares in his favour using the derivative without making such disclosures, the share would have an artificially depressed price, and investors who sell their shares during that time period received lesser prices for their shareholding.[382]

- *Secondly*, the disclosure norms in Takeover legislations are designed to regulate share volatility.[383] Thus, withholding continual disclosures and subsequently disclosing ownership of a large stake in the company at once can bring about high volatility in the share price once the disclosures are finally made. For instance, when Porsche did disclose its 30% equity interest in Volkswagen via equity derivatives in October 2008, Volkswagen's shares underwent high volatility, even briefly making it the most valuable share in the world.[384]
- *Lastly*, circumventing such disclosures prevents the extant management of the company from preparing itself from a hostile takeover attempt, and gives the hostile acquirer an undue time advantage.[385]

IV. INTERNATIONAL PERSPECTIVE ON DISCLOSURE OF EQUITY BACKED DERIVATIVES

The issue of Equity Backed Derivatives, while unaddressed in India, has been extensively deliberated upon in other mature jurisdictions like the UK, USA, EU, etc.

382 *Glencore International v. Takeovers Panel*, [2006] FCA 274.
383 Henri Conac (n 4) at 52.
384 *Id.*
385 Takeovers Regulations Advisory Committee (n 2) at ¶16.3.

The issue first came up in the US in the case of *The Children's Investment Fund LLP v. CSX Corporation*,[386] wherein, the Court of Appeals for the Second Circuit held that cash settled equity derivatives like TRS do not raise disclosure requirements under the Securities Exchange Act of 1934. The Court unequivocally settled the issue by holding that even if commercial practices meant that the Appellant had a genuine expectation of acquiring the reference shares from the short party, the same would not amount to an agreement or a common intent between the parties, as no legal entitlement of acquisition existed in the contract.[387] The ruling is significant because the issue was decided in this manner despite the US having an anti-abuse provision within the Securities Exchange Act, 1934 which seeks to catch such forms of indirect acquisitions.[388] Similar rulings have also been given by Courts in other mature jurisdictions such as Germany (in the case of *Schaeffler v. Continental AG*),[389] Australia (in the case of *Glencore International AG v. Takeovers Panel*)[390] and New Zealand (in the case of *Ithaca Custodians v. Perry Corporation*).[391]

In the last decade, however, there has been an increasing trend of countries adopting legislations to explicitly cover equity interests held

[386] 654 F.3d 276.
[387] *Id.*
[388] Rule 13(d)-3B, Securities Exchange Act, 1934, See Also Umakanth Varottil, 'CSX/TCI Judgment: Some thoughts on the SEBI Takeover Regulations',(IndiaCorpLaw, June 17, 2008), available at: https://indiacorplaw.in/2008/06/csxtci-judgment-some-thoughts-on-sebi.html.
[389] Press Release, 'No Breach of Reporting Requirements Identified in Continental AG Takeover', (The Federal Financial Supervisory Authority, August 21, 2009), available at: http://www.bafin.de/SharedDocs/Veroeffen-%20tlichungen/EN/Pressemitteilung/2008/pm_080821_conti.html.
[390] [2006] FCA 274.
[391] [2003] 2 N.Z.L.R 216 (H.C).

in the form of such derivative transactions within their takeover legislations. In the UK, the Financial Services Authority in 2009 amended its Disclosure and Transparency Rules and the Financial Services Authority Act, 2000, which now mandates undertakings to make disclosures of financial instruments having a 'similar economic effect' to financial instruments already covered in its regime, which included shares which crossed the 5% threshold of a public company.[392] Similarly, in 2011, the Securities Trading Act in Germany was amended to include cash settled financial instruments such as cash settled TRSs within the disclosure norms.[393] Subsequently, the European Parliament amended its Transparency Directive in 2015 to require disclosure of long positions held by investors in financial instruments referencing shares of public listed companies, including instruments that were cash settled. Most recently, the Takeovers Panel in Australia issued a Guidance Note which requires undertakings to disclose their long positions in publicly traded companies if such position is of 5% or more of the equity capital of the company.[394]

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[392] 'Notification Of The Acquisition Or Disposal Of Major Shareholdings, In Disclosure Guidance And Transparency Rules Sourcebook, DTR 5.3.1(b)' *(*UK Financial Services Authority, March 2020), available at: https://www.handbook.fca.org.uk/handbook/DTR.pdf.

[393] Securities Trading Act (WpHG) 1998, s 25a (Germany).

[394] 'Guidance Note 20: Equity Derivatives', (Australia Takeovers Panel,2020), available at: https://www.takeovers.gov.au/content/DisplayDoc.aspx?doc=guidance_notes/current/020.htm&pageID=&Year.

V. CONCLUSION

Cash settled equity derivatives, despite the leverage they provide to the long party in acquisition of the underlying reference shares, as well as the developments in other countries like the EU, UK, etc., are still outside the purview of the disclosure requirements under India's Takeover Regulations. While arguments in favour of including such long positions within the disclosure requirements have been deliberated at length in the present paper, it must be acknowledged that there are some arguments against such inclusion as well. The most pertinent among these is that including cash settled derivatives within the disclosure norms could risk information overflow, wherein information that is not even relevant for corporate governance and takeover issues may be included in company-wide disclosures, thereby actually burdening the average investor with an overflow of information.[395]

The author is however of the opinion that there exists a legitimate policy objective in including cash settled derivative transactions, especially if they are used as objects to acquire stakes in a public company, within the disclosure norms. To alleviate concerns regarding information overflow, the author suggests that exemptions could be included within the disclosure norms to weed out derivative transactions with a legitimate economic interest. For instance, in the UK, while the takeover laws provide for disclosure of cash settled long positions in a public company, the norms do not apply to client facing

[395] Stankovic (n 8) at 300.

financial servicing intermediaries,[396] provided that the shares or options held by them do not exceed the threshold of 5%.[397] Further, the investor only needs to disclose those shares which the short party to the transaction needs to hold to hedge its position under the contract, and not the entire quantum of the reference shares in the transaction.[398] Further, the disclosure norms do not apply in case the financial instruments are acquired solely for the purpose of clearing and settlement within a settlement cycle.[399]

Keeping the same in mind, the author is of the opinion that Regulation 29 of the Takeover Regulations should be amended to ensure that while cash settled derivative transactions relevant from a takeover perspective are caught, other instruments having no bearing on corporate control of public companies are not. Such a move would increase information symmetry within the securities market, thereby also increasing investor sentiment and confidence in the market.

[396] Notification Of The Acquisition Or Disposal Of Major Shareholdings, In Disclosure Guidance And Transparency Rules Sourcebook, DTR 5.3.2B' *(*UK Financial Services Authority, March 2020), available at: https://www.handbook.fca.org.uk/handbook/DTR.pdf.
[397] *Id.* at D.T.R 5.1.3(R)(4)
[398] *Id.* at DTR 5.3.3A
[399] *Id.* at DTR 5.1.3.1.