ECONOMIC
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ELP KNOWLEDGE SERIES

India Update

Part 3 of 2019

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FOREWORD

Dear Reader,

We welcome you to the latest edition of ELP Knowledge Series, a quarterly analysis of curated topics pertaining to critical legal and regulatory developments that can affect businesses in India.

This iteration of 'India Update – Part 3 of 2019' addresses a range of current issues pertaining to disputes between PE investors and promoters, GST related pain points for key industry sectors, rights of minority shareholders and changing regulations or increasing issues of sexual harassment.

This edition also contains a discourse on select topics which warrant an interactive dialogue between government and industry, such as the growing relevance of treaty arbitrations for Indian businesses, an opportunity for India to reform its trade policies against the backdrop of the US-China trade wars and examination of a Sovereign Guarantee/Letter of Comfort as an enabler for liberalization of foreign investment in India. We conclude our edition with an overview of the budget and its current impact on industry.

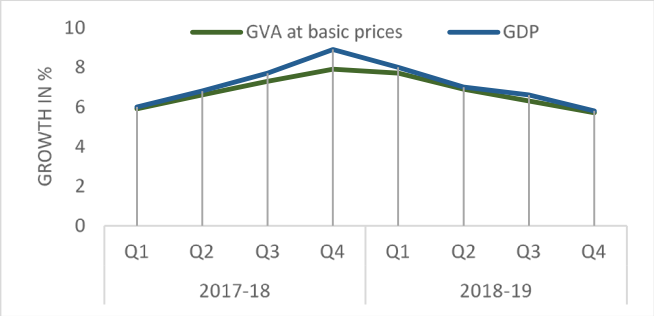
We hope you will find this information helpful. For any clarification or further information, please connect with your point of contact at ELP or reach out to us at insights@elp-in.com.

Regards,
Team ELP

INDIAN ECONOMY - A SNAPSHOT

Economic growth

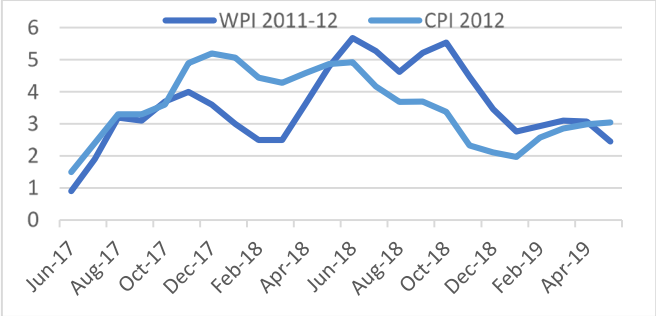
Quarterly Growth of GDP and GVA (%) at constant '11-12 prices



***Source**: Central Statistical Organisation (CSO)*

Inflation

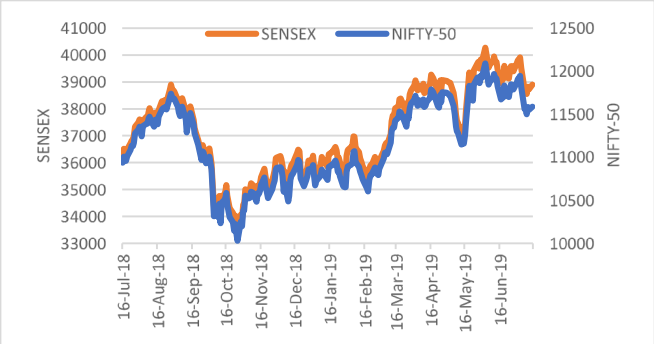
Inflation in WPI and CPI (%)



***Source**: Office of Economic Adviser-DIPP and CSO*

Share Market

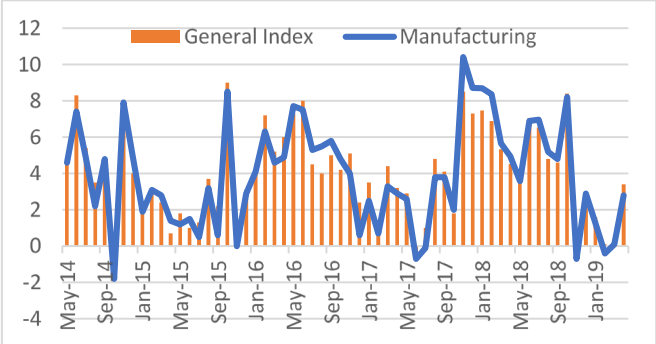
SENSEX and NIFTY-50



***Source**: BSE and NSE*

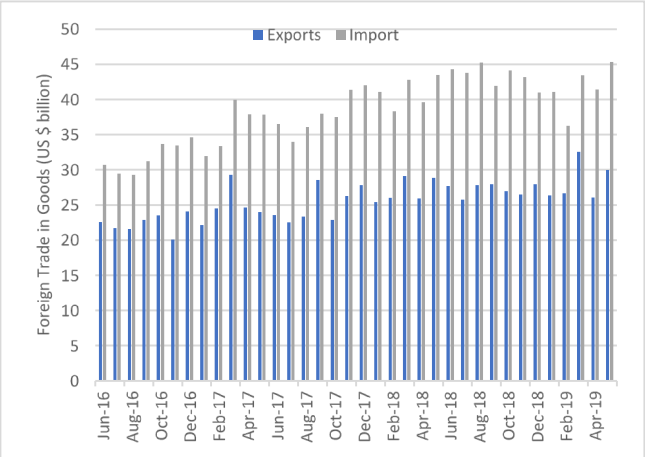
Production growth

Index of Industrial Production (IIP) growth in %



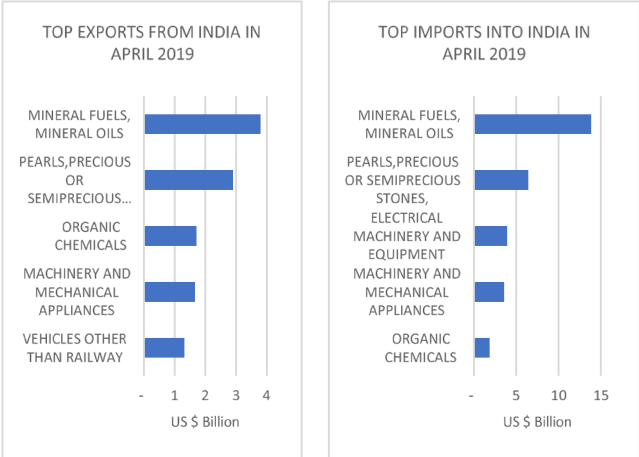
***Source**: CSO*

External trade



***Source**: Ministry of Commerce*

Major goods traded



***Source**: Ministry of Commerce*

India's Union budget: Seeking the pot of gold at the end of the rainbow

The first budget post the BJP's thumping victory in the elections, has been rich on intent and has something to offer every constituency – from startups to NBFCs and everyone in between. Though the objective for the path ahead seems focused on growth – be it reform in FDI, 'ease of living' through 'less government and maximum governance', infusion of capital in the PSU banks, government guarantees for lending to NBFCs or strategic disinvestment – the budget has also brought with it its own set of issues.

This article succinctly analyzes a few highlights of the Union Budget from the three viewpoints of the macro economy, implications for corporates and implications for the individual.

EXPENDITURE

The government proposes to spend INR 27,86,349 crore in 2019-20, which is 13.4% above the revised estimate of 2018-19.

RECEIPTS

The receipts (other than net borrowings) are expected to increase by 14.2% to INR 20,82,589 crore, owing to higher estimated revenue from corporation tax and dividends.

GDP GROWTH

The government has assumed a nominal GDP growth rate of 12% (i.e., real growth plus inflation) in 2019-20. The nominal growth estimate for 2018-19 was 11.5%.

DEFICITS

Revenue deficit is targeted at 2.3% of GDP, which is higher than the revised estimate of 2.2% in 2018-19. Fiscal deficit is targeted at 3.3% of GDP, lower than the revised estimate of 3.4% in 2018-19.

Source: Ministry of Finance

THE UNION BUDGET: EFFORTS TO DRIVE GROWTH

Providing a massive boost to infrastructure through a proposal to spend approximately INR 100 lakh crore in the next 5 years, it is clear that the government is looking towards this sector to drive economic growth. To fund this growth, the government has proposed a number of measures including a renewed focus on PPPs, formation of a Credit Guarantee Enhancement Corporation and deepening the market for long term bonds (with a specific focus in infrastructure). The government has also allowed investments made by Foreign Institutional Investors (**FIIs**) and Foreign Portfolio Investment (**FPIs**) to be transferred or sold to any domestic investor within the specified lock-in period.

In a landmark move, the government has proposed to raise a part of its gross borrowing program through external markets in the form of external currencies (most popular of which is the US dollar). Varied viewpoints have been expressed on this count. The optimistic school of thought believes that this is a positive move which will ensure easier access to domestic funds by private borrowers (usually competing with government borrowings for the same pool). There is an equally strong opposition to sovereign dollar borrowings: the belief being that with India's large budget deficit, "*faddish investors buying when India is hot, and dumping us when it is not*" (quoting Raghuram Rajan) and higher principal payments for the government if the rupee falls against the dollar at the time of redemption, putting India's external debt at a higher risk. Overall, the move is no doubt a bold one, however it will take 4-5 years to evaluate in which direction the needle has moved.

With an intent to boost digital payments, the finance minister introduced a step to levy TDS of 2% on cash withdrawal exceeding INR 1 crore in a year from a bank account. The finance minister proposed that business establishments with an annual turnover of over INR 50 crores should offer low cost digital modes of payment such as BHIM UPI, UPI-QR Code, Aadhaar Pay, certain

Debit cards, NEFT, RTGS etc. to their customers with no charges or merchant discount rate (**MDR**) being imposed on customers or merchants. Again, while this move is to underpin the efforts of the government towards a cashless and transparent economy, it has created a pandora's box of problems for the payment industry which is confused on how the cost of digital transactions would be covered. As per the industry, the proposal to levy no merchant discount rate will prove disastrous to the non-bank players as they do not have any other recourse avenue other than the MDR.

In a positive move aimed at revitalizing the NBFC sector, the government will provide one time six months' partial credit guarantee to Public Sector Banks for first loss of up to 10% for the purchase of high-rated pooled assets of financially sound NBFCs, amounting to INR 1 lakh crore for the current year. Further, the finance minister in the budget speech also spoke of resolving the conflict of National Housing Bank (**NHB**) acting as a lender and regulator to Housing Finance Companies (**HFCs**) and proposed for the RBI to be the new regulator to HFCs in India. Given that NHB is a subsidiary of RBI, most regulations governing NBFCs and HFCs are not poles apart and it may not have a major impact on the day to day regulatory aspects of the HFCs. However, it would be interesting to see if RBI comes up with a separate set of regulations for HFCs including in relation to the affordable housing segment. Also, in continuation with the Government's previous effort to restore the financial health of the public sector banks, the Government has now proposed to further provide INR 70,000 crores for recapitalization.

To summarize, the government is hoping to revive a sluggish economy by an investment driven model. However reviving investment by only relying on just domestic consumption is perhaps not realistic enough. This years' Economic Survey clearly makes the case for an exports-led growth which is indispensable to any approach that puts investment first.

THE UNION BUDGET: DOING BUSINESS IN INDIA

The government seems to have kept its intent of lowering the corporate tax rate in a phased manner. The tax rate of 25% which was earlier applicable to companies with an annual turnover of INR 250 crores has been widened to cover companies with a turnover of INR 400 crores. This however seems at odds with the investment narrative as large companies will continue to remain less competitive as the total effective tax rate, including the dividend distribution tax, is as high as 48.31%. The only silver lining seems to be for companies investing in electronics and advanced technologies where tax incentives have been offered irrespective of the size of the companies.

Clarifications on the issue of the much debated "angel tax" have given the start-up sector a reason to cheer. The Finance Minister has assured industry that the funds raised by the start-ups will not be subject to "scrutiny" by the income-tax authorities. Additionally, a separate mechanism is proposed to be set-up for e-verification of the investor and source of funds. Accordingly, the income-tax authorities can no longer challenge or reject the valuation of the share premium arrived by the start-ups. Also, in continuation with the intent of the Government to promote the start-ups, the Finance Minister has proposed to exempt the investments by Category II AIF from the purview of angel tax.

The Government's proposal for allocating about INR 350 crores for the 2% interest subvention scheme for all GST registered MSMEs on fresh or incremental loans for FY 2019-20 would provide a much-needed fillip for the MSME sector. Further, loans up to INR 1 crore are proposed to be provided within 59 minutes through a dedicated online portal and for all payments to MSMEs from the Government: for this, a payment platform is proposed to be created for MSMEs to enable filing of bills and payment on the platform itself.

Another positive note has been the modification of the FDI rules in sectors such as aviation, insurance, media segments, and single-brand retail and announcing efforts to deepen the bond markets.

Introduction of hike in surcharge for the super-rich (non-corporate), however, has set the proverbial cat amongst the pigeons for FPIs, more so with the Finance Minister ruling out any relaxation norms for FPIs (which are typically structured as trusts). This has the potential to affect close to 40% of the FPIs in India and resultantly FPIs have flushed out INR 5,673 crore from domestic equities, being

net-sellers on 11 out of the 13 trading sessions (*Source: Business Standard Report*). Again, this does not augur well for a country which is looking to grow on investments.

The budget proposal of tax buybacks of shares of listed companies has further compounded the problem. Earlier, the buy-back of shares vis-à-vis distribution of dividend provided significant tax arbitrage to the listed companies – the government has now closed that gap.

Another downside is the proposal to increase minimum public shareholding in listed companies to 35% which could negatively impact some companies. Resultantly, the industry is grappling with concerns on promoters choosing to delist, SEBI ensuring this compliance especially in relation to PSUs and impact on MNC's (which generally have a higher level of shareholding).

THE UNION BUDGET: TAXATION PERSPECTIVE FOR INDIVIDUALS

While the budget did not provide much incentive to the middle or lower-income groups, it has been a cause of massive distress to the super-rich. With the surcharge, effective tax rates for high income individuals with a taxable income above INR 2 crores is 39% and for individuals with a taxable income between INR 2 crores and 5 crores is 43.74%. Further, many of the super-rich who had formed trusts to avoid inheritance tax (if introduced) are now in a quandary as this tax is applicable to trusts also. Implications of this tax include dampening investor confidence, forcing the wealthy to find loopholes or relocate to other countries. All of which again does not bode well for India from an investment perspective.

The positives for the individual taxpayer, amongst others, are manifested in the budget through a further push towards affordable housing, easier filing of tax returns, tax exemption of entire withdrawal of NPS and tax exemptions on the purchase of EV's.

CONCLUSION

The Union budget 2019 has been rich on intent and identifies sufficient strategic points to jump-start growth and has big bang impact opportunities which is aimed at driving the economy – start-up ecosystem, borrowing in global markets, FDI reform, tweaking customs duty to benefit industries of the future such as electric vehicles and solar energy to 'Make in India' and further investment in infrastructure.

How does the government intend to fund this? This budget indicates that corporate tax will be the main contributor to the nations' revenues. Is this a prudent and sustainable way forward? To quote William Churchill, "*I contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle.*"

There were huge expectations of reinvigorating the economy from the first budget of the Modi 2.0 government. Industry pandits expected a budget that would rejig the economy with a focus on employment, improving labor reforms, overhauling direct taxes, more liquidity in the market and a further push towards attracting investments. Whether the budget ticked all the boxes is debatable. It is however clear that this budget was big on continuity and low on change.

Private equity – Shareholders' rights and areas of potential disputes

INTRODUCTION

Keeping pace with the evolution of private equity (**PE**) investments as a mainstream source of funding, there has been a commensurate increase in differences and conflicts with investee companies, promoters and other stakeholders. Such disagreements arise on multiple grounds, ranging from corporate governance, contractual rights & obligations, board nomination and investor exit amongst others. Many of these provisions are documented in a shareholders' agreement (**SHA**) or an investment agreement. This article focuses on the key contractual legal rights and obligations in SHAs that engender disputes between PE investors and promoters as well as the effective mitigation, response and resolution strategies.

CONTRACTUAL RIGHTS AND OBLIGATIONS

PE Investors and the promoters typically negotiate their legal rights and obligations in relation to the following:

- **Pre-investment liabilities and status of the business, employees, pending litigations, existing contracts and tax & regulatory compliance:** Representations and warranties (**R&Ws**) form the basis on which an investment is made by the PE investor in so far as factual matters for the period prior to the investment are concerned. From an investment transaction point of view, R&Ws are documented in the form of negative or positive factual assertions from the promoters (such as confirming if the investee company does not have any regulatory or third party litigation, if all material business contracts are subsisting and have not been terminated, or confirming that the books of accounts of the investee company reflect its true and accurate financial position). If there are exceptions to ensure that the R&Ws are not breached, the promoters furnish relevant factual disclosure in the form of a disclosure letter. From a documentation standpoint, PE investors usually insist on the promoters to back-stop a breach of R&Ws or a misrepresentation of R&Ws by way of an indemnity. Pursuant to this, should a breach of R&Ws occur, it gives the PE investor the right to seek monetary claims against the promoter.

BREACH OF R&W AND JUDICIAL INTERPRETATION

Telenor Asia (P) Ltd. Vs. Unitech Wireless (Tamil Nadu) (P) Ltd. And Others[1]

Based on several representations and warranties made by Uninor regarding the validity and compliance with the licenses required under applicable laws, Telenor entered into a share subscription and shareholders agreement with Uninor and made an equity investment of INR 6,135.62 crore. Subsequently the licenses granted to Uninor were cancelled. Telenor alleged that Uninor had committed a fraud by making false representation and warranties, and, therefore, it had the right to rescind the shareholders agreement and declare it a nullity. They also asked that a board resolution be passed in Uninor to the effect that the company should transfer its entire business to a Telenor affiliate entity at a fair market value to be determined by an independent valuer. This matter was ultimately referred to an arbitral tribunal by the Company Law Board. The decision is not accessible to the public as yet.

- **Post-investment oversight – board nomination:** Whilst as a minority financial investor, PE investors do not usually take the onus of day-to-day operations of the investee company, they usually insist on appointment of a nominee on the board of directors. Where the clause does not provide for requirement of approval of the other shareholder, the appointment must be immediate. Further, the presence of such nominees is also required to

[1] *Telenor Asia (P.) Ltd. v. Unitech Wireless (Tamil Nadu) (P.) Ltd. and Others*, CA No. 149 of 2012 in CP No. 32 (ND)/2012

constitute a valid quorum for a meeting of the board of directors.

- **Veto rights of the PE investor and share transfer restrictions:** Under the Companies Act (**Act**), certain actions of the company require consent of shareholders of the company either by way of an ordinary resolution (which requires a simple majority of the shareholders) or a special resolution (which requires ¾ of the votes in favor of that resolution). In addition to this, PE investors may negotiate to have veto on certain matters. This contractually negotiated right ensures that despite having a minority stake in the company, PE investors have the right to veto certain actions that could potentially affect their investment as well as influence certain critical decisions of the investee company. Usually, veto rights are in relation to raising further debt or equity funds, issuance of shares, approval of accounts, business plans and annual budgets, acquisition or divestment of new business, hiring or terminating key employees as well as statutory auditors. It is pertinent to note that the courts have allowed clauses in the articles that have a higher threshold than those of the Act where the Act is silent on that matter.[2]

- **Exit rights:** Exit related rights are critical for PE investors. Set out below are some of the key aspects of exit provisions and attendant judicial interpretation:

  - **Obligation of promoter to provide exit on a 'best effort' basis:** While exit rights are extremely important for investors, from the promoter's perspective it is not an absolute obligation since exit is dependent on several factors such as macroeconomic conditions, regulatory framework affecting the industry and other conditions beyond the control of the promoter. In recognition of this aspect, the exit obligation of the promoters is negotiated to be on a 'best effort' basis, or exit terms and valuation are based on the approval of the PE investor.

In *Yewbelle Ltd. v. London Green Developments Ltd. & Anr.*,[3] the claimant (**Seller**) and the defendant (**Purchaser**) entered into a property sale agreement, conditional on obtaining a planning agreement with the London Borough of Merton under s. 106 of the Town and Country Planning Act, 1990.

The Seller had agreed to use "all reasonable endeavors" to obtain this agreement. However, the contract did not contain any deadline or any provision for its termination if it were not possible to satisfy the condition. By March 2006, the condition remained unsatisfied and the Seller decided to terminate the contract, contending that it had used all reasonable endeavors to obtain a s. 106 agreement, but that this was not practical as it turned out that a third party owned part of the land. It would be necessary to either purchase that part of the land or make the additional landowner a party to the s. 106 agreement (both of which would, it was argued, be very expensive in practice).

It was held that that the obligation to use all reasonable endeavors "requires you to go on using endeavors until the point is reached when all reasonable endeavors have been exhausted." The court opined that based on the facts, the Seller had failed to take reasonable endeavors to resolve the obstacles presented by the third-party land ownership. The Seller appealed and the court of appeal endorsed the lower court's analysis of what constituted all reasonable endeavors but upheld the appeal in relation to the lower court's analysis of the facts, asserting that Seller had in fact used all reasonable endeavors.

- **Put option:** Put options are structured in a way that empower the PE investor to require the investee company or the promoter to purchase the securities held by the PE investor at a pre-agreed price or at a fair market value, if the PE investor has not exited. Put option clauses are negotiated either to be on the investee company or personally on the promoters.

[2] *Kapil N Mehta, Surat v. Shree Laxmi Motors Ltd.*, (2001) 103 Comp Cas (Guj.) 498
[3] *Yewbelle Ltd. v. London Green Developments Ltd. & Anr*, [2007] EWCA Cjy 475

- **With regards to the investee company, the put option is implemented via a buy-back as per the provisions of the Companies Act.** Under the Companies Act, the investee company is required to buy-back its shares or specified securities out of its free reserves, or the securities premium account or the proceeds of the issue of any shares or other specified securities. Additionally, the buy-back should be authorized by the articles of association and approved by ¾ shareholders of the investee company and cannot be more than 25% of the aggregate paid up capital and free reserves of the investee company in any financial year. There are other procedural conditions to be complied by the investee company for undertaking a buy-back of shares.

- **A put option in relation to promoters is** governed by the Indian contract law and, if the investee company is a listed company, the regulations under the Securities and Exchange Board of India Act, 1992 and the guidelines and circulars issued by the Securities and Exchange Board of India (SEBI) are also applicable. Post October 2013, put options in relation to listed companies have been expressly permitted by SEBI subject to the following conditions: (i) the PE investor should hold the securities for a minimum of 1 year, (ii) the price for the sale and purchase of the security has to be in compliance with applicable laws, and (iii) the put option has to be settled by actual delivery of the underlying securities.

- **Non-resident PE Investor:** If the PE investor is a person resident outside India in both the above circumstances, the provisions of the Foreign Exchange Management Act, 1999 and the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 (**FEMA 20R**) are applicable. The pricing guidelines prescribed under FEMA 20R for a transfer of a shares by a person resident outside India (i.e. a PE investor) to a person resident in India (i.e. the promoter or the investee company) require such transfer to be at a price not exceeding (i) the price as per the guidelines and regulations prescribed by SEBI in case of a listed company and (ii) the price as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI registered Merchant Banker or a practicing Cost Accountant, in case of an unlisted company. In addition, FEMA 20R specifically provides that the guiding principle would be that the person resident outside India is not guaranteed any assured exit price at the time of making such investment/agreement and shall exit at the price prevailing at the time of exit. "Hence, put options on the investee company or the promoters cannot be at a pre agreed price or return and will need to be at the price prevailing at the time of exit."

JUDICIAL INTERPRETATION OF PUT OPTIONS AND EXIT AT A PRE-AGREED PRICE

In the case *Cruz City 1 Mauritius Holdings v. Unitech Limited*[4] as well as *NTT Docomo Inc v. Tata Sons Limited*[5] the Delhi High Court upheld the put option clause in the investment agreement. Its validity was argued on the grounds that a put option at a pre-determined price or an assured return was not allowed on FDI as provided under the RBI circular dated January 9, 2014. However, the court held that that the put option was conditional upon non completion of the project and as a result of a breach of contract and not an assured return as proscribed under the RBI circular.

In *MCX v. SEBI*[6], MCX offered to issue shares to Punjab National Bank on preferential basis with an exit option. FTIL, the promoter, had the right to buy back the shares from PNB at any time after one year from the time of investment. It was held that in such an arrangement, the person who is making an offer to buy back the securities, the promisor, cannot compel the exercise of the option by the promise. A concluded contract for purchase and sale of shares only comes into existence when the option to sell shares is exercised. If the option were exercised, there is nothing to indicate that it would be anything but a spot delivery contract.

[4] *Cruz City 1 Mauritius Holdings v. Unitech Limited*, EX.P.132/2014 & EA(OS) Nos.316/2015, 1058/2015 & 151/2016 & 670/2016.
[5] *NTT Docomo Inc v. Tata Sons Limited*, O.M.P.(EFA)(COMM.) 7/2016.
[6] *MCX v. Securities and Exchange Board of India*, 2012 SCC Online Bom 397.

Legal metrology laws in India – Issues and challenges

INTRODUCTION

The Legal Metrology Act, 2009 (**LMA**) and Legal Metrology (Packaged Commodities) Rules, 2011 (**PCR**) are the primary instruments available to the Government for protecting consumer interest and ensuring consumer awareness. LMA and PCR prescribe the mandatory declarations required to be made on retail packages, including details such as Maximum Retail Price (**MRP**), name and address of the manufacturer, packer and importer, contents and size of the commodity, month and year in which the commodity is packed or imported, contact details in case of consumer complaints etc. Manufacturers, packers and importers are accordingly required to obtain registrations under the LMA. This article analyzes the recent amendments to LMA by the government, impediments faced by the industry, cost of non-compliance (especially in light of the recent increase in traction from Legal Metrology Department (**LMD**)) and effective mitigation strategies.

RECENT AMENDMENTS

The PCR have witnessed periodic amendments, with the latest amendment coming into effect from 1 January 2018. Key developments include:

- Introduction of obligation on e-commerce entities to make mandatory declarations[7]
- Declaration requirements being extended to medical devices notified as 'drugs'
- Increase in the prescribed font size, with grandfathering provided up to 31 July 2018
- Prohibition of declaration of different MRPs (dual MRP) on an identical pre-packaged commodity
- Declarations required on food products being harmonized with labelling requirements under Food Safety (FSS) laws

CONSEQUENCE OF NON-COMPLIANCE

Ensuring compliance with LMA and PCR becomes crucial in light of the following factors:

- The enactment governs aspects which are directly perceived by the end-customer and thus the reputational risks involved are high
- Applicable fines in case of multiple offences lead to larger pecuniary consequences
- The time-cost of the top officials (i.e. directors, etc.) for attending proceedings etc. would be high
- While a remote possibility, one also needs to be mindful of the consequence of prosecution and imprisonment in case of a third or subsequent offence

As regards consequence in case of sale of non-standard packages which do not conform to the mandatory declarations, (i) a fine of up to INR 25,000 is prescribed for the first offence, (ii) a fine up to INR 50,000 for the second offence, and (iii) for subsequent offences, a fine between INR 50,000 to INR 100,000 is payable and/or punishment with imprisonment (which may extend to one year). Prosecution may also be initiated if no response is received in relation to a particular notice. Equal penalties are also prescribed for the directors of the companies (however, in cases where a company nominates a director under LMA, these penalties are imposable only on that particular director).

AVENUES OF MITIGATION

In cases of non-compliance, there are mitigating steps which can be explored.

- **Compounding of offence** is allowed for certain offences under the Act, including incorrect declaration on the package. For this purpose, the necessary compounding fees, (which cannot be more than the applicable penalty), can be paid which will ensure that there are no further proceedings initiated in relation to the offence. However, once compounding of an offence is done, there is an embargo on opting for compounding for the same offence if committed within three years. Compounding may help a defaulting company to avoid prosecution, imposition of consequent penalties and imprisonment of designated directors.

[7] with lesser degree of compliance prescribed in case of market-place e-commerce entities.

- **Clubbing:** Though not prescribed under the law, manuals issued by certain States provide for a mechanism of 'clubbing' of offences. If several cases are booked within a State in relation to the same commodity of the same entity by different inspectors for violation of the same section/rule under the LMA and Rules, all such cases may be clubbed together and treated as a single offence and compounded.[8] If available, this avenue is advisable to opt for in order to avoid multiple proceedings at different locations in relation to the offences booked for the same commodity.

ISSUES AND CHALLENGES

Primary challenges to effective compliance with LMA and PCR stem from (a) inherent ambiguity in the law itself, and (b) varied interpretation by State level officers who are actually entrusted with its enforcement. A few illustrations are:

- **Name and address of the manufacturer:** The PCR requires the declaration of the name and address of the manufacturer and if the packaging is done by a person other than the manufacturer, the name and address of the packers. However, there exists room for ambiguity as regards whose name is required to be disclosed in case packaged commodities are manufactured by third parties on behalf of the principal/brand owners. This can be juxtaposed with the FSS regulations which clearly mandate that the names and addresses of both the brand owner and the third-party manufacturer must be mentioned on the package.

- **Determination of the size of the Principal Display Panel (PDP) in case of rectangular packages:** The PCR prescribes the mandatory font size for the declarations to be made which is determined in terms of the height and width of the side which 'can properly be considered to be the principal display panel' without providing adequate or specific guidance, which leaves significant room for subjective interpretation by different officers.
  Further, certain departmental officers have also taken an obtuse view that the label ought to be pasted on the entire PDP area. On this issue, an FAQ available on the website of Ministry of Consumer Affairs clarifies that there is no such requirement of the label to cover the entire PDP area, as long as information is grouped together at one place and printed as per the prescribed font size.

- **Understanding what is a first, second or subsequent offence:** There is no definition of what qualifies as 'offence' and accordingly what can be understood as a first, second or subsequent offence. A single batch of products containing a non-compliant declaration may, from the perspective of the company, be viewed as a single lapse, whereas when these products are spread across the country these may be understood differently by respective LMDs at the State level. This will also impact how clubbing and compounding of the said offence can be undertaken.

- **Compounding on a pan-India basis:** While LMA is a central legislation, its provisions, including those relating to compounding, are enforced at the State level. Hence even if a company realizes a specific breach in relation to goods sold across the country, it might face difficulty in opting for compounding of offence on a pan-India basis, and it will have to evaluate the option of compounding at each State. Further, LMDs do not seem acceptable to the idea of compounding on a *suo-moto* basis and would typically require a notice to be issued first before initiating the proceedings.

CONCLUSION

While the purport of LMA is to benefit consumers, in view of the inherent ambiguities, its enforcement may result in placing trade and commerce at a disadvantage. It would indeed be helpful for businesses if the concerned authorities can define specific aspects that can lead to non-compliance and clarify the ambit of various notices and proceedings, so that a concerted and harmonious stand is adopted before various departmental officers across the country and the avenues of clubbing and compounding of offence are availed in the most prudent and efficient manner.

[8] Clubbing can be initiated after notices have been issued and before compounding is opted for.

India Inc and treaty arbitrations

India India executed its first bilateral investment treaty (**BIT**) in 1994 with the United Kingdom. The subsequent years witnessed a proliferation of BITs with several nations on account of the 'liberalization wave' that swept the country in the 90's. Simply put, BITs were a bundle of protections that India promised to a foreign investor and which would have been extended to an Indian investment, in the counterparty's country as well. However, given the intense inbound capital focus characteristic during the early liberalization period, these treaties acted more to provide a sense of security to a foreign investor coming into India as opposed to the other way around.

More than two decades down the line, India remains one of the more popular FDI destinations around the globe; however, outward FDI from India has also increased exponentially. Consequently, the BIT paradigm has changed as well and must now ensure that Indian investments outside India remain protected too. Through this note, we attempt to showcase India's experience with BITs, investor state dispute settlement (**ISDS**) and certain pivotal aspects of the 2016 Model BIT.

ISDS AND INDIA

Over the last few decades, several disputes have arisen with regards to BITs. Since India is not a party to the International Centre for Settlement of Investment Disputes Convention ICSID (**ICSID**), treaty disputes invoked against India are conducted under United Nations Commission on International Trade Law Rules (**UNCITRAL Rules**) and administered by the Permanent Court of Arbitration at the Hague (**PCA**).

India has thus far executed 84 BITs:

- 61 have been terminated
- 20 remain in force
- 3 BITs, though signed, are not in force as of today (Belarus, Colombia & Democratic Republic of Congo)

Treaty arbitrations were invoked against Government of India by foreign investors on account of judicial delays[9], alleged discriminatory measures in the telecom[10] and power sectors[11] and on certain other instances due to retrospective tax measures[12] and concessions being revised.[13] Of the 24 arbitrations invoked against India, 9 arbitrations were settled (all arise out of disputes pertaining to the Dabhol Energy Project), 1 has been decided in favor of the investor and 1 has been decided in favor of the State. The remaining arbitrations are either pending, or where settlement discussions have ensued between the parties.

From the other standpoint, Indian investors have invoked treaty arbitrations on 6 occasions. Of these arbitrations, 3 remain pending, while on one instance the arbitration was decided in favor of the investor and another arbitration was settled.

Given the sheer number of disputes, the Government of India announced its decision of terminating the existing BITs in 2016 (after releasing the Model BIT in 2015).

[9] Arbitration proceedings invoked by White Industries under the India – Australia BIT
[10] Arbitration proceedings initiated by Astro Holdings, KHML, Devas, Deutsche Telekom and Naumachenko under India – Malaysia, India – Mauritius, India – Germany and India – Russia BIT respectively
[11] Arbitration proceedings initiated by Bechtel (India-Mauritius BIT), ABN Ambro (India-Netherlands BIT), ANZEF (India-UK BIT), BNP Paribas (India-France BIT), Credit Lyonnais (India-France BIT), Credit Suisse (India-Switzerland BIT), Erste Bank (India-Austria BIT), Offshore Power (India-Netherlands), Standard Chartered (India-UK BIT)
[12] Arbitration proceedings initiated by Vodafone (India-UK BIT & India-Netherlands BIT), Cairn & Vedanta (India-UK BIT)
[13] Arbitration proceedings initiated by Nissan (India-Japan EPA), Kowepo (India-South Korea CEPA), Carissa Holdings (India-Mauritius BIT), RAKIA vs India (India – UAE BIT)

ISDS AND THE GLOBAL SENTIMENT

In the year 2018, there were a total number of 41 ISDS cases filed. Colombia was the most frequent respondent, with six known cases, followed by Spain with five. Belarus, Qatar and Rwanda – faced their first known ISDS claim. There is a strong perception among various practitioners that ISDS regime is anti-developing nation and that it favors investors.

The statistics however reflect a different position. ISDS mechanism in the past, has been invoked against Czech Republic, Canada, Germany, Italy, Poland, Spain and USA as well and indeed, of the 942 ISDS instances, 215 have been decided in favor of State and 173 have been decided in favor of investor. It may, however, be noted that historically the ISDS regime has been utilized predominantly by investors from developed states, with the highest number of cases were being filed from the USA and the Russian Federation.

ANALYZING THE MODEL BIT

The government had released its Model BIT in the year 2015, on the basis of which it planned to negotiate any future BIT with another sovereign state. Additionally, the intent was to either renegotiate the existing treaties or execute joint interpretative statements in addition to the bilateral obligations. While the terminated BITs continue to hold good given the sunset clauses in each of them, the renegotiated BITs will only come into effect once the same are finally executed and ratified. Certain specific aspects of the Model BIT are analyzed in the following section.

EXTENSION OF PROTECTION

The Model BIT extends protection to an *"enterprise [...] that has the characteristics of an investment such as the commitment of capital or other resources, certain duration, the expectation of gain and profit, the assumption of risk and a significance for the development of the [host State]"* (Art. 1.4). This definition essentially takes note of the test applied to protected investments in *Salini Costruttori S.p.A. and Italstrade S.p.A. v. Kingdom of Morocco*[14]. While several arbitral tribunals have not followed the criteria laid down in Salini, the Model BIT has clearly placed reliance on the same and aims to restrict protection only to those investments which satisfy all the mentioned criteria.

The Model BIT also does not offer any protection over portfolio investments, loan or debt securities issued by the government, any pre-investment activities (*including "any pre-operational expenditure [...] before the commencement of substantial business operations [...]"*), money claims arising from trade in goods and services or from commercial transactions, goodwill/brand value/market share or similar intangible rights as well as a judgment or an award (Art. 1.4). For the avoidance of doubt, any "pre-investment activities" (Art. 2.2), matters of taxation (Art. 2.4(ii)) and services that are supplied by the government on a non-commercial basis (Art. 2.4(vi)) fall outside the scope of protection offered by the revised Model BIT.

KEY EXCLUSIONS AND INCLUSIONS

While the Model BIT prohibits violations of customary international law that amount to a denial of justice, fundamental breach of due process, targeted discrimination and manifestly abusive treatment (Art. 3.1), it does not include a broader Fair and Equitable Standard (**FET**), a common feature in international investment arrangements.

The Model BIT does not implement a Most Favored Nation (**MFN**) clause, thus protecting against a foreign investor's reliance on a more favorable regime of protection in place between India and a third party under another India BIT. Instead, the revised BIT relies on the National Treatment standard (Art. 4), which states that a foreign investor must not receive less favorable treatment than a domestic investor of the host State.

DISPUTE RESOLUTION CLAUSES

The Model BIT provides for an elaborate dispute resolution clause. The exhaustion of local remedies is thus a pre-condition for referral to arbitration (Article 15), except where the foreign investor can demonstrate that no local remedies

[14] *Salini Costruttori S.p.A and Italstrade S.p.A v. Kingdom of Morocco*, ICSID Case No. ARB/00/4

capable of reasonably providing any relief are available. Following exhaustion of local remedies for a minimum period of 5 years, and a further cooling-off period of six months (Art. 15.2), the disputing parties may initiate arbitration by serving a notice of dispute. The initiation of arbitration is, however, subject to a number of strict additional conditions precedent, including the following:

- The lapse of six years since the investor first became aware of a loss caused to his/her investment
- The lapse of twelve months since conclusion of any domestic proceedings
- A notice of arbitration (by way of a formal consent to arbitration (Art. 17) having been served ninety days before initiation of the arbitration

A foreign investor that meets the conditions precedent has a choice to refer to arbitration under:

- The ICSID Convention
- The Additional Facility Rules of ICSID
- The UNCITRAL Arbitration Rules

INDIAN INVESTORS' PERPECTIVE – KEY RISKS TO MITIGATE

In the year 2018, while the cumulative amount of FDI inflow into India was around USD 42 billion, outward FDI amounted to USD 11 billion (including equity, guarantees and loans). Such significant outbound FDI levels serve to suitably underpin the need for ISDS for India. The companies which have invested overseas need to be made aware of the protections that are available to them by way of international treaties.

- It is becoming increasingly critical for the Government of India to execute instruments which may take into consideration the outbound investments, given the fact that some of these investments have been made in places which have been classified as 'high risk jurisdictions.' Indian companies which do not directly invest in another nation but indirectly route the investment through a third nation will not be offered any protection under the Model BIT.
- The exclusion of an FET standard from the Model BIT – a protection that most of the BITs offer, is a further cause of concern for an outbound investment, as it is much broader than the restrictive protections that the current Model BIT offers. The absence of an MFN clause will further restrict an outgoing investor from invoking protections that the Host State would have offered through other BITs.
- India's outbound investments are not only in developed jurisdictions but also in nations where court systems may not be well developed. An Indian investor may therefore have to litigate for a long duration (first domestic courts then arbitration proceedings) before it actually receives any compensation through the invocation of an arbitration under the existing Model BIT.
- The Model BIT excludes non-discriminatory regulatory measures from the purview of expropriation as well as measures or awards by judicial bodies. While India has thus affirmed its stand that any measure by a judicial body aiming to protect public interest will be outside the purview of expropriation, this should be a matter of concern for the investors who invest in nations where independence of a judicial process may be questionable.

CONCLUSION

There is no doubt that India needs to leverage foreign capital to trigger its ambitious growth of being a USD 10 trillion economy. Likewise, Indian investors are increasingly looking overseas to diversify their business, gain access to new markets, procure intellectual property and undertake research and development. BITs will increasingly be a part of the India growth narrative. Assuring foreign investors of a stable business environment in which their interests will be protected is as critical as safeguarding Indian investors capital overseas.

India may have a fair share of treaty arbitrations invoked against it, and the Model BIT too may have its naysayers, however the intention of equitable treatment on which the BIT system is rooted cannot be debated. India may have to rethink certain protectionist measures in its Model BIT going forward but at least we are headed in the right direction.

GST implications on 'transactions in securities'

Securities' (shares, scrips, stocks, bonds, derivative instruments, etc.) have been explicitly excluded from the purview of GST, by virtue of their exclusion from the definition of 'goods' and 'services', as per Section 2(52) and Section 2(102) of the CGST Act respectively. However, even while not being a taxable transaction itself, a transaction in securities has several other implications in terms of GST law. This arises pursuant to treating such transactions as 'exempted' supplies for the purpose of determination of admissible input tax credit for the entity.

WHETHER THE GST PROVISIONS EXPLICITLY REQUIRE REVERSAL OF INPUT TAX CREDIT?

Cognizant of the fact that several businesses engage in transactions in securities even while it is not part of their core business – usually such transactions are undertaken for efficient deployment of unused funds or for hedging commodity prices and currency exposures – the GST law has sought to ensure that Input Tax Credit (ITC) attributable to such activities undergoes reversal.

Section 17(2) and Section 17(3) of the CGST Act read with Explanation 2(a) to Chapter V of the CGST Rules, seek to achieve this. Relevant provisions are given below:

Provision	Relevant extract
Section 17(2)	Where the goods or services or both are used by the registered person partly for effecting taxable supplies including zero-rated supplies under this Act or under the Integrated Goods and Services Tax Act and partly for effecting exempt supplies under the said Acts, the amount of credit shall be restricted to so much of the input tax as is attributable to the said taxable supplies including zero-rated supplies
Section 17(3)	The value of exempt supply under sub-section (2) shall be such as may be prescribed, and shall include supplies on which the recipient is liable to pay tax on reverse charge basis, transactions in securities, sale of land and, subject to clause (b) of paragraph 5 of Schedule II, sale of building
Explanation 2(a) to Chapter V of the CGST Rules	For the purposes of this Chapter, ...(2) for determining the value of an exempt supply as referred to in sub-section (3) of section 17-... (b) the value of security shall be taken as one per cent. of the sale value of such security.

'Securities' whether exempt?

While the intention of the Government is clearly reflected in the aforesaid provisions, the application needs to be examined. It is noted that Section 17(2) of the CGST Act casts a restriction on availing ITC to the extent it is attributable to an 'exempt supply'. As per Section 2(47) of the CGST Act, the term 'exempt supply' means supply of goods or services which are exempted, or which attract nil rate of GST and includes non-taxable supply. Non-taxable supply is further defined under Section 2(78) to 'mean such supply on which no tax is leviable. Therefore, to constitute an exempt supply/non-taxable supply of goods or services, the pre-requisite test of being a supply of either has to be met. Since 'securities' find an exclusion from the ambit of 'goods' and 'services' itself, the question of it qualifying as an exempt or a non-taxable supply would not arise, more so when the said terms are exhaustively defined.

The question which arises is whether Section 17(3) does enough to overcome the limitation placed under Section 17(2), so as to achieve the legislative intent. Unfortunately, a plain reading of the provision suggests that it fails to get the job done. As evident, the said provision is merely assigned the task of determining 'value of exempt supply' under sub-section (2). It, however, exceeds such authority and attempts placing therein 'transactions in securities', even when the same does not constitute a supply in the first place. A 'notwithstanding clause' or a deeming fiction stretching/expanding the scope of the term 'exempt supply' to include within its ambit 'transactions in securities' could have unequivocally empowered the legislature to neutralize ITC attributable to the said activity.

Quite clearly, there is an ambiguity as to whether the law, as drafted, requires ITC reversal for transactions in securities. It may, therefore, be relevant to refer to the findings of the Constitution Bench of the Hon'ble Supreme Court in the case of *Commissioner of Cus. (Import), Mumbai vs. Dilip Kumar & Company* [15], wherein it was held that while interpreting a taxing statute, there is no room for intendment or presumption and that it has to be interpreted only on the basis of language employed, and any ambiguity in taxing provisions has to be interpreted in favor of the assesses.

However, an interpretation that there is no requirement for reversing ITC attributable to transactions in securities would render the applicable extract of Section 17(3) redundant and would be contrary to the settled law, inter alia, in terms of the decision of the Hon'ble Supreme Court in the case of *CCE, Calcutta vs. Hindustan Petroleum Corpn. Ltd.*[16], that an interpretation which ignores words, or which renders words superfluous, cannot be taken.

To conclude, there is a visible gap between the intent and the letter of law under the present GST law, which may inevitably lead to litigation in which case possibly another retrospective amendment may be on the anvil.

WHETHER THE QUANTUM OF ITC REVERSAL SOUGHT IS COMMENSURATE WITH THE QUANTUM OF ITC USAGE?

Assuming that transactions in securities necessitate reversal of ITC, it needs to be seen whether the mechanism currently prescribed, achieves a reasonable and realistic reversal, commensurate to the extent of common services consumed in the course of the subject activity.

It is noteworthy that only a miniscule quantum of common infrastructure is directly consumed in such activity, primarily pertaining to employee costs, which are not within the ambit of GST, and certain other costs such as IT infrastructure, internet services etc. However, in terms of Rule 42 of the CGST Rules, the moment an activity qualifies as an exempt supply, all common input services, which may not be exclusively attributable to taxable/exempt operations, will have to undergo reversal. To this extent, various services-whose procurement is not determinant on conduct of the subject transactions e.g. office rent, legal and audit, security etc.- will suffer the brunt of ITC reversal. To this extent, the reversal mechanism appears to be arbitrary and unreasonable. On the contrary, it would have more logic if ITC reversal could have been restricted only to such inputs and input services, which are directly connected to transactions in securities.

WHETHER HEDGING TRANSACTIONS, WHICH ARE INHERENTLY LINKED TO TAXABLE SUPPLIES, MERIT ITC REVERSAL?

Many entities which deal in commodities where prices are exchange determined (such as industrial metals, precious metals, etc.) often enter into commodity derivative transactions with the sole objective of hedging their future procurements or supplies from any adverse price movements. Similarly, entities who make procurements or supplies which require cross border settlement may enter into currency derivative transactions solely for securing foreign currency exposure.

[15] *Commissioner of Cus. (Import), Mumbai vs. Dilip Kumar & Company*, [2018 (361) E.L.T. 577 (S.C.)]
[16] *Calcutta vs. Hindustan Petroleum Corpn. Ltd.*, [2005 (189) E.L.T. 258 (S.C.)]

It may be pertinent to note that any gain or loss arising out of such derivative transactions is proportionately linked to the corresponding variation in price at which the taxable supply is eventually made. In effect, no gain or loss independently arises on account of the derivative contract.

For better understanding, consider this illustration. a simplistic illustration is provided below. Mr. X, a trader in certain commercial Imetals, intends to supply a certain quantity of the same after a month. Mr. X apprehends that one month hence, the price of such commodity may fluctuate. In order to hedge the pricing risk, he enters into a forward sell contract in such commercial metals with a month's maturity at a strike price of USD 20,000. Assuming that at maturity the market price is (a) USD 15,000, or (b) USD 25,000, the following alternative scenarios would emerge:

Particulars	Market price (USD 15,000)	Market price (USD 20,000)
1. Strike price of forward sell contract	USD 20,000	USD 20,000
2. Market price at the time of maturity*	USD 15,000	USD 25,000
3. Profit (loss) on forward sell contract [1-2]	USD 5,000	(USD 5,000)
4. Net effective consideration received, owing to the hedging transaction [2+3]#	USD 20,000	USD 20,000

*Note: -To offset his position, Mr. X will generally enter into a forward buy contract of equal denomination, price of which will be near equivalent to the market price

#Price received on supply of goods (market price at maturity) + profit (loss) on the forward derivative contract

As evident, under either scenario, Mr. X is guarded from any price fluctuation, by virtue of the derivative contract and receives an identical overall consideration in respect of its taxable supplies. Thus, the only objective of entering into such derivative contracts is to secure the price of taxable supplies, which is equivalent to the strike price of the derivative contract. However, as already enumerated, derivative contracts qualify as 'securities' and any transaction therein, notwithstanding whether it is for trading or for hedging purposes, would necessitate ITC reversal. Therefore, seeking ITC reversal for transactions which are carried out as a part of the taxable business and for securing the price of taxable supplies being made under GST appear to be onerous, inappropriate and unreasonable.

In this regard, it is also relevant to note that jurisprudence under the Income Tax laws clearly recognizes such hedging transactions as forming part of normal business operations rather than speculative business operations. These hedging transactions cannot be construed as transactions independent of such business. This issue perhaps merits an active dialogue with the Government. It is no doubt beneficial for industry to seek exclusion for the activity of hedging from the ambit of 'transactions in securities.'

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Global trade wars: An opportunity for India to implement long term reforms

While the United States-China trade war has dominated the debate on global trade order and its future, there has been a silent and calibrated attack on India's domestic policies at the WTO in recent years by several countries (such as the United States, Canada, Australia and Brazil). These countries have been questioning some of India's export promotion schemes and domestic support measures for agricultural products such as rice, wheat, cotton, pulse and sugarcane and sugar before the WTO Committee on Agriculture (**COA**).

CHALLENGES AT THE WTO

When India graduated from Annex VII of the WTO Agreement on Subsidies and Countervailing Measures (**SCM Agreement**) in 2017, the United States began challenging some of the key export promotion schemes of India in 2018 resulting in dispute DS 541 (India – Export Related Measures). By way of background, Annex VII of the SCM Agreement lists out certain developing countries against whom a claim with respect to subsidies contingent on export performance (which are prohibited under the SCM Agreement) cannot be made. However, the protection of Annex VII is not available if a developing country crosses the GNI per capital for USD 1000 for three consecutive years. India crossed the cap in the year 2017.

In particular, the United States filed its first counter notification on India's minimum price support program for rice and wheat before the COA in May 2018,[17] which was followed by another counter notification on cotton in November 2018.[18] Subsequently in May 2019, the United States and Canada issued another counter notification on pulses in February 2019.[19] In November 2018, Australia issued a counter notification against India on sugar before the COA.[20]

Earlier this month, Australia, Brazil and Guatemala have requested for establishment of a panel challenging several federal and state-level measures supporting the sugarcane and sugar industry.[21]

While all these disputes are sub-judice, there is no doubting the fact that India is under extensive scrutiny at the global trade forum. If the present government aims to achieve its ambitious economic milestones – especially doubling its agri-exports and farmers' income – it is time to relook at some of these domestic policies and take appropriate measures to address the concerns raised at the WTO. These targets cannot be achieved without private investments across industry sectors, which rely on certainty and predictability in domestic policies. One of the key factors to gain investor confidence is to demonstrate that India's domestic policies are consistent with the WTO rules and they are there to stay. Undoubtedly, with many of these policies facing challenge at WTO, we need to adopt transformative reforms.

WHAT ARE THE KEY ISSUES?

In the ongoing dispute DS 541 (India – Export Related Measures), the United States has challenged certain key export promotion schemes including Export Oriented Units (EOU scheme), Merchandise Exports from India Scheme (**MEIS**), Export Promotion Capital Goods Scheme (**EPCG**) and Special Economic Zones scheme (**SEZ**) that offer tax incentives contingent upon export performance. Article 3.1(a) read with Article 3.2(b) of the SCM Agreement prohibits Member States to maintain or grant subsidies contingent upon export performance.

[17] https://www.fas.usda.gov/newsroom/united-states-issues-first-ever-wto-counter-notification-against-india-s-market-price
[18] https://ustr.gov/about-us/policy-offices/press-office/fact-sheets/2018/november/united-states-issues-wto-counter
[19] https://www.thehindu.com/business/us-and-canada-raise-wto-counter-notification-on-indias-msp/article26284820.ece
[20] https://www.thehindubusinessline.com/economy/agri-business/australia-takes-india-to-wto-over-sugar-subsidies/article25514617.ece
[21] https://economictimes.indiatimes.com/news/economy/foreign-trade/wto-to-consider-setting-up-panels-to-probe-disputes-against-indias-sugar-subsidies-next-week/articleshow/70249002.cms?from=mdr

In the agri-sector, most of India's domestic support measures that are under scrutiny at the WTO pertain to price support programs. The domestic support measures that pertain to market price support for any product are distortive under the WTO Agreement on Agriculture (AoA).

These are also known as "amber box" subsidies. The developing countries that did not undertake any reduction commitments during the Uruguay Rounds of negotiation cannot exceed product-specific domestic support in excess of 10% of the value of the production of the basic agricultural product. Annex 3 of the AoA provides a formula to calculate market price support which is essentially calculated against a fixed external reference price that existed in the years 1986 to 1988. Most of the counter notifications issued against India contend that India's market price support for products such as wheat, rice, cotton, sugarcane, are well beyond the 10% limit when compared to the fixed reference price prevailing in base years (i.e. 1986 to 1988).

WHAT COULD BE THE WAY FORWARD FOR THE GOVERNMENT?

While the jury is still out on the merits of the above concerns, India can take this opportunity to reform its domestic policies such that they are sustainable over the long term. In this regard, the government may consider:

- **Export policy revamp by phasing out some of the current export promotion schemes and adopting new policies that are protected under Annex I of the SCM Agreement:** To clarify, any subsidy that is contingent on export performance is prohibited. Annex I of the SCM Agreement lists out illustrations of prohibited export subsidies and also provides that certain types of remission/exemption/drawback of indirect taxes or import charges on inputs to be used in production of goods for export would not be considered as export subsidy if they are not in excess of taxes on inputs levied for home market consumption (i.e. the "excess remission principle" under paragraphs (h) and (i) of Annex I) and satisfy conditions set out in Annex II and some of the existing export promotion schemes such as Advance Authorization that are modelled around the excess remission principle.

  However, exports under the schemes are repeatedly countervailed by foreign countries on the grounds of lack of transparency in input-output norms and verification mechanisms. The government may consider remodeling its export schemes to the extent the same is allowed under Annex I and taking appropriate steps to make the input-output norms and verifications mechanisms objective and transparent.

- **Domestic support to agri-sector by reforming the total subsidy package:** While the amber box support may be problematic, the government may consider reforming its total subsidy package in sync with Annex 2 of the AoA which allows for "green box" expenditures. These subsidies are generally not product-specific, and payments include expenditures with infrastructure, research, environment and direct payments not related to production. As an illustration, the PM-KISAN scheme that guarantees direct cash transfer of INR 6,000 annually to farmers is likely to qualify as a green box support. [22]

These reforms are not easy given the social and political sensitivities around the medium, small and micro enterprises and agri-sector. However, in view of the concerns raised at the WTO, the government is looking at policy initiatives to reform some of its existing export subsidies and make them WTO-compliant.[23] With the government pro-actively looking at change, this also may be the right time for businesses to initiate a dialogue with the government on their economic interests, concerns that they might have and the way forward.

[22] http://www.pmkisan.gov.in/
[23] "Govt proposes WTO-compliant schemes to boost Make in India", Livemint, May 27, 2019.

GST rate reduction to 5% in the real estate sector: A winning stroke or a run out?

The real estate sector in India has faced several headwinds over the past few years. Demonetization in 2016, the introduction of GST in 2017 and the NBFC crisis in 2018. The question now is whether the revised scheme of GST will be a similar event in 2019.

At the outset, sale of a property pre and post construction, by a developer, has been treated differently for the purpose of levy of indirect taxes. This basic issue still bothers the sector as both the transactions eventually entail the sale of an immovable property.

Be that as it may, the scheme of taxation for this sector has been continuously changing. With this recent change, this sector is evidencing the 5th regime of taxation, within a decade. The facts are presented in the table below.

Period	Taxability	ITC (Input tax credit)	Taxation on development rights
Prior to 2005	Not liable	Not available	Not liable
2005 - 2010	Disputed but finally held to be liable for VAT and Service Tax	VAT – allowed Service Tax- not allowed	Not liable but disputed by VAT authorities
2010 - June 2017	Taxable to VAT & Service Tax	VAT – not allowed Service Tax – allowed	While not liable but disputed not only by VAT but also Service Tax authorities
July 2017- March 2019	Liable to GST	Full ITC available	Taxable
April 2019 onwards	Liable to GST	No ITC	Exempt to the extent of sale prior to Completion Certificate

The basic ethos underlying the implementation of GST was revenue neutrality which means that the tax burden essentially pre and post GST regime remains the same. However, Real Estate sector stands out in revenue neutrality approach not being maintained, as evidenced from the fact that up to March 31, 2019, the GST rate of an under-construction property was 12% (effective tax rate). This proved to be a massive jolt to the real estate industry which was anyway struggling to stay afloat.

Post several representations made by the industry and based on the recommendations of the GST Council, the Ministry of Finance finally notified a revised scheme whereby a GST rate of 5% without ITC, would be applicable to the sale of an under construction residential unit.

However, we need to carefully consider whether this revised scheme of 5% GST without ITC is more beneficial than 12% with ITC? Though the optics seem very good, on analyzing the finer details, one can infer that this move does not actually tilt the balance favorably to the sector or the consumer. The government has effectively retained the same tax burden and, in fact, developers and consumers might be worse off in many instances.

To understand the real impact of the GST rate reduction, it is important to understand the hidden effects of denial of input tax credits on the costs of construction and on the marketing costs. In the extended suburbs of metros and in Tier II and Tier III cities, the ratio of cost of construction and marketing (Cost) to Sales Price (SP) is high as 45% to 50%. Consequently, the overall tax burden borne by the customer will now under the revised scheme is in the range of 14-15% (in metro suburbs, Tier II and Tier II cities). Illustrating this with an example.

Sale price (SP)	COC	Total tax cost		Effective tax cost		Additional tax burden
A	B	C = A*5%	D= B*20%	E= C+D	Till March 31, 2019 [F=A*12%]	(E-F)
100	45	5	9	14	12	2

Note: Most of the construction related goods and services fall in 18% rate slab however cement continues to be under 28%. For the sake of calculation, ITC is computed on an average rate of 20%.

In a nutshell, the tax costs in the transaction is likely to be more and not less as would be expected.

It is also important to view the issue from the lens of anti – profiteering. Any reduction in rate of tax should ideally result in decrease in cost for the customer. This is the very core of the principle of anti- profiteering. However, what does a developer do in a scenario where due to the non-availability of ITC, the costs of the project have actually increased? Currently though, the anti-profiteering authority may expect the benefit of a lower rate of GST to be passed onto the customer, after adjusting the loss of credit. Establishing the increasing costs before the anti-profiteering authority while still adhering to the anti-profiteering principles is now a challenge to the developers.

Adding to the industry woes, the states of India have increased stamp duty by 1%. For example, in Maharashtra the stamp duty has been increased to 6%. At best, this move of reduction to 5% has achieved certainty for the industry. While the customer is correct in expecting a lower price of housing, developers are facing their own set of woes – while they need to meet customers' expectations and pass on the lower rate of GST, the denial of ITC has squeezed them from both ends of the spectrum. Is this rate reduction, therefore, a winning stroke or run out?

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Prevention of sexual harassment in the hospitality industry: Whose cross is it to bear?

The past two years have witnessed an increased awareness regarding sexual harassment of women at the workplace throughout the world. The #MeToo movement has compelled organizations to reconsider their HR practices to ensure the establishment of adequate safeguards for prevention of any form of sexual harassment at the workplace and effective redressal mechanisms.

Given the nature of the contractual relationship of a hotel owner (**Owner**) and a hotel operator (**Operator**), a common point of contention on hotel management contract negotiations is the responsibility for compliance with laws. Considering that the Hotel employees are hired and trained by the Operator, the Owner usually expects the Operator to undertake the obligation of complying with the law. Interestingly however, although policies are often set by the Operators, contractually the onus is placed on the Owner and the purported position of the Operator as a mere service provider does not admit to a clear legal obligation for compliance with various employment legislations.

WHO IS RESPONSIBLE?

Under a hotel management agreement (**HMA**), more often than not, hotel employees are designated as employees of the Owner. This is despite the fact that the Owner has little or no control in matters relating to employees. Customarily, it is usually the Operator who selects and hires, exercises day-to-day supervision and control over the employees and formulates the HR policies and guidelines The Owner often has no say in disciplinary actions or dismissal of employees. Given this typical arrangement, the question that needs to be addressed then is who is responsible under the law for prevention of sexual harassment- the Owner or the Operator?

A few years ago, the Sexual Harassment of Women at Workplace (Prevention, Prohibition and Redressal) Act, 2013 (**Act**) was formulated by the Indian Government.

The Act requires an 'employer' to take certain prescribed actions for prevention of sexual harassment at the workplace and is inter alia applicable to a private unit or undertaking carrying on any commercial activities, including provision of any services.

An employer has been defined under the Act to mean, any person responsible for the management, supervision and control of the workplace. Persons discharging contractual obligations with respect to his or her employees could also be considered within the ambit of an 'employer'.

Taking into consideration the definition of an 'employer' under the Act, it may be contended that both the Operator and the Owner can be considered as an 'employer' for the purposes of the Act. Whilst the Operator is responsible for the management, supervision and control of the workplace, the Owner is liable under the HMA to discharge obligations towards its employees.

ACTIONS TO BE TAKEN

Most Operators have anti-sexual harassment policies in place across the brand which they usually extend to the employees of hotels in which they provide their services. Operators also typically undertake the onus of constituting the Internal Complaints Committee (ICC) as required under the Act for addressing complaints of sexual harassment. However, they are wary of undertaking any liability for non-compliance of statutory provisions.

Given that the Operator is in-charge of the hotel employees and formulates policies in respect of such employees, it may be deduced that the Operator is responsible for compliance of the

Act by inter alia undertaking the following actions:

- Organizing workshops and awareness programs at frequent intervals for sensitizing the employees
- Organizing orientation programs for members of the ICC
- Assisting aggrieved women in filing complaints, and
- Monitoring timely submission of reports by the ICC

The Operator may also be required to ensure that the order constituting the ICC and the consequences of sexual harassment are displayed at a conspicuous place in the workplace. The Operator may additionally have to undertake investigation of the complaints and the witness statements to examine the accuracy of the claims and information provided. At times this could entail forensic examination of electronic data, footprints and records available through mobile devices and laptops to gather and preserve electronic evidence.

Considering that the Owner may also be construed as an employer, the Owner should ensure that all of the aforesaid actions are undertaken by itself or the Operator. Usually Owner's expect the Operator to only formulate a policy for prevention of sexual harassment, constitute the ICC and inform them regarding any complaints received by or against any employees. However, it is time, that this obligation be extended beyond that. Owner's may consider monitoring compliance of the Act by seeking the requisite details in the MIS reports provided by the Operator.

SAFETY TO BE OF PRIME IMPORTANCE

Regardless of who takes on the responsibility over the hotel employees or of complying with the Act, it is important not to overlook the main objective. The hospitality industry is an industry with a high level of human interaction. Harassment in such an industry is not just limited to that inter se the employees but may also extend to cases amongst guests and employees. It may be noted that the Act covers acts of sexual harassment not only of employees but any persons at the workplace. Operators may need to be mindful of the fact that even though they may disclaim liability for any non-compliance or violation of the Act by the hotel employees, a reported case of sexual harassment can be catastrophic for the brand image.

The importance of taking stock and necessary measures to address sexual harassment at the workplace cannot be emphasized enough- whoso-ever's cross it may be to bear- the Owners' or the Operators' – ultimately the hospitality industry is all about people.

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Minority protection against oppression and mismanagement

INTRODUCTION

Chapter XVI of the Companies Act, 2013 (**Act**) provides for minority protection against oppression and mismanagement. Ordinarily, the board of directors of a company is empowered to take decisions binding the company, and outsiders including courts are not permitted to interfere in its affairs. However, when the management of a company purports to conduct its business in a manner prejudicial to the interests of the company, its shareholders, or a minority group of shareholders, its shareholders are empowered under Chapter XVI to approach the court to redress the wrong.[24]

APPLICATION FOR RELIEF AGAINST OPPRESSION AND MISMANAGEMENT

Section 241(1) of the Act provides that shareholders of a company can apply to the National Company Law Tribunal (**NCLT**) for relief against oppression and mismanagement if:

- Its affairs are carried out in a manner prejudicial or oppressive to certain members of the company, to the company's interests, or to public interest; or
- There occurs a change of management, control, ownership of shares, membership, or other change, that is likely to result in the affairs of the company being conducted in a manner prejudicial to its own interests, or the interests of its members or a certain class thereof (unless such change is brought about by its creditors, debenture holders, or a class of its shareholders, or in their interest).

ELIGIBILITY TO APPLY FOR RELIEF AGAINST OPPRESSION AND MISMANAGEMENT

Section 244 of the Act provides that an application for relief under Section 241 should be made by at least 100 members, or one tenth of the members of the company, whichever is less, or members holding at least one tenth of the total issued share capital of the company. Applicants should have paid all calls on capital, and other sums due in respect of the shares held by them.

The NCLT, however, has been empowered to waive the above eligibility requirements at its discretion. As a quasi-judicial body, a waiver by the NCLT is required to be made on merits and with a reasoned order, rather than capriciously or arbitrarily.

The corresponding provision in the Companies Act, 1956 was Section 399, which also contained similar eligibility requirements. The power to waive the requirements, was vested with the Central Government, and was thus an administrative power rather than an investigatory/judicial power.

In *Cyrus Investments Private Limited and Others v. Tata Sons Limited and Ors.*[25], the National Company Law Appellate Tribunal (**NCLAT**) has held that in order to determine whether an application for waiver should be granted, the NCLT is not only required to form an opinion objectively, but to also satisfy itself on the basis of pleadings/evidence on record, as to whether:

- The applicant is a member of the company in question
- The proposed application pertains to "oppression and mismanagement"
- A similar allegation was earlier made by any other member, and was decided and concluded, or
- There are other circumstances that merit the grant of waiver to enable filing of application under Section 241

In Cyrus Investments (supra), the NCLAT, overturning the decision of the NCLT, granted waiver on various grounds, including that since no minority shareholder could individually initiate action under Section 241 (despite having financial interest to the extent of one sixth of the total value of the subject company) the 10% requirement of Section 244 of the Act should be dispensed with.

[24] Company Law. (2014). 4th ed. Haryana: Taxmann
[25] *Cyrus Investments Private Limited and others v. Tata Sons Limited and Ors.* [2019} 212 CompCase 269

ITC V. LEELA AND OTHERS INTERVENTION

ITC Limited (**ITC**) filed a petition on April 23, 2019, against Hotel Leela Venture Limited (**Leela**) with the National Company Law Tribunal (**NCLT**), Mumbai, alleging "oppression and mismanagement". Since ITC holds only 8.27% of the share capital of Leela, it has also applied for an exemption of the requirements under Section 244.

In the petition, ITC has sought injunctions restraining Leela, its promoters, directors and JM Financial ARC (**JM**) from the sale and transfer of the assets of four hotels and one property to BSREP III India Ballet Pte. Ltd. (**Brookfield**). ITC has alleged that the transaction is skewed in favor of the promoters and JM and opposed to the interests of minority shareholders, including itself.

ITC further alleges that the proposed transaction would have the effect of transferring a substantial part of Leela's assets in favor of Brookfield, resulting in diversion of Leela's revenue stream to Brookfield and leaving Leela with no real business prospects, while it retained large liabilities, which it would be unable to service. According to ITC, the interests of Leela, and its minority shareholders would be prejudiced by the transaction. The decision of the NCLT is yet awaited.

Given the route that ITC has taken, it appears that the company currently does not enjoy any contractual protection of its rights as a shareholder of Leela. Accordingly, if on the basis of the facts, the NCLT does not grant ITC a waiver, ITC may either choose to

- Appeal against the order of the NCLT, or
- Form a cohort with other shareholders of Leela to collectively meet the 10% requirement and make a fresh application, or
- Increase its shareholding in Leela to 10% in order to meet the requirement under Section 244 of the Act, and thereafter make a fresh application

- however, in the given circumstances, it seems unlikely that ITC will choose to invest more of its funds in the Leela.

The NCLT ruling is expected to be synchronous with recent legislative thrust on transparency and objectivity in corporate governance. The ruling on ITC's waiver application will also serve as important guidance for measures to be put in place, and steps to be taken by corporate India to avoid judicial intervention in its management and affairs.

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Is sovereign guarantee/letter of comfort an enabler for liberalization of foreign investment in the Indian defense sector?

INTRODUCTION

India has long aspired to create a domestic military-industrial complex that can help the country modernize its defense capabilities and reduce the disproportionate reliance on imports. However, despite a spate of policy and regulatory reforms, no substantial foreign investments have been made in this sector of late.

Continuing its focus on easing the entry barriers, the Draft Defense Production Policy, 2018 now seeks to further liberalize FDI in the defense sector and permit *FDI up to 74% under the automatic route in niche technology areas.* If the proposal is brought into effect, then foreign players would be able to acquire a controlling stake in an Indian entity engaged in niche technology areas in the defense sector without the approval of the Indian Government. This will significantly change the industry dynamics – while the proposal is rooted in attempts to address the highly skewed import to indigenization ratio in the country, there are no precedents in other jurisdictions for allowing such acquisition of control.

While FDI in this sector is heavily regulated across the world (including in the United States of America, Russia, Japan, France and Germany), most countries have either imposed certain restrictions on foreign participation, not permitted acquisition of control or have mandated the requirement of prior approval of the government for acquisition of stake beyond a certain percentage.

Given this backdrop, it would be important to analyze the consequences of providing a controlling stake to a foreign stakeholder in an Indian entity engaged in the defense sector and certain protective measures that would be critical in mitigating potential risk.

ACQUIRING A CONTROLLING STAKE: CONCERNS AND ADVANTAGES

Currently, under the extant foreign exchange laws in India, FDI in the defense sector is permitted up to 100%, but the approval of the Government is required for crossing the 49% mark, which would depend upon the nature of the investments that are "likely to result in access to modern technology or for other reasons to be recorded". However, the conditions for obtaining the approval of the government for FDI beyond 49% have not been explicitly set out and the government has the prerogative to approve each investment on a case to case basis. This lack of clarity with respect to the conditions that may be imposed by the Indian Government has resulted in a regulatory black box.

While one of the obvious advantages of providing a foreign stakeholder a controlling stake in an Indian entity engaged in the defense sector is the heightened inclination of the foreign partner to share technical know-how, there is a clear need for ensuring greater accountability and responsibility.

Consider the following scenario: If a foreign stakeholder obtains a right to nominate majority directors on the board of directors of the Indian entity, such nominees (who would have the power to make decisions of the Indian investee entity) can be held accountable for any failure to meet supply obligation or any deficiency in the quality of the defense equipment manufactured by the Indian entity and sold to the Government of India. This can prove to be a major concern for the government.

In order to address similar situations, we recommend a sovereign guarantee or a letter of

comfort that may be considered by the Ministry of Defense, Government of India, whilst liberalizing FDI in the defense sector in order to mitigate potential adverse impact (from delay in supplies, deficient quality, etc.) on India's military readiness.

GENSIS OF SOVEREIGN GUARANTEES AND LETTERS OF COMFORT

The power to issue a sovereign guarantee and letter of comfort usually emanates from the Constitution of a country (the Government of India has the power to issue such guarantees under Article 292 of the Constitution of India). A sovereign guarantee is a guarantee for discharging the liability or obligation of a third party from the government of a nation to the government of a foreign nation, which is legally enforceable and binding in nature. A letter of comfort is akin to a sovereign guarantee, but it is not legally enforceable in a court of law. A letter of comfort from the foreign Government may be considered as a moral obligation in the eyes of the public and any default thereof may become a matter of international embarrassment for the foreign country.

It is not novel for India to obtain a letter of comfort or a sovereign guarantee from a foreign state. As can be gathered from media reports, a letter of comfort was given by the French Government under the Rafale Deal and a sovereign guarantee was given by the Russian Government under certain other defense deals. While such provisions put an additional obligation on the foreign OEM, Government of India can seek this additional comfort from foreign investors seeking to cross the 49% threshold in order to ensure continuity of supplies in times of national, political or economic crisis.

Since the issuance of sovereign guarantees or letters of comfort is confidential in nature and details of issuance of any such guarantee to the Government of India backing the performance of a foreign entity are not available in public domain, we have only seen such guarantees forming a part of inter-governmental agreements or contracts with foreign government for foreign military sale of defense equipment. However, the viability of such safeguard mechanisms has not been tested for investments under the FDI route.

CONCLUSION

The Government of India should consider a progressive approach to enhance FDI in the defense sector resulting in prospective transfer of technology, which would be invaluable to the Indian defense sector. As such, granting a controlling stake in Indian entities to foreign investors seems to be the need of the hour, but such rights should be intertwined with checks and balances.

Hence, if a foreign investor can produce a Sovereign Guarantee or Letter of Comfort, the Ministry of Defense should consider liberalizing the FDI norms beyond 49% under automatic route with such safeguard mechanisms. The Indian defense opportunity is immense and it will now be up to the new government to further smoothen the road ahead.

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