NALSAR

STUDENT LAW REVIEW

Vol. 7 2012

student bar council | nalsar university of law

NALSAR
STUDENT LAW REVIEW
Vol. 7 2012

EDITORIAL BOARD

This issue shall be cited as 2012 (7) NSLR <page no.>

Contents

NALSAR University of Law, Hyderabad
Justice City, Shameerpet, Hyderabad - 500 078, R.R. Dist., India
Tel : Office : +91-40-23498102 Res : +91-40-23498151
Fax : +91-8418-245161
E-mail : veersingh_14@yahoo.co.in Website : www.nalsar.ac.in

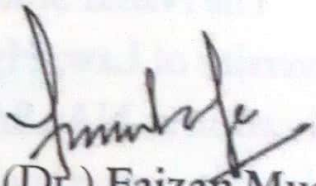
Prof. (Dr.) Faizan Mustafa
Vice-Chancellor

From the Vice-Chancellor's Desk

The Nalsar Student Law Review [NSLR] is the flagship publication of NALSAR University of Law, Hyderabad. A totem of the growing tradition of legal research and publication at NALSAR, the NSLR is a periodic law review committed to publishing writings on contemporary legal issues and developments by students across law schools in India and abroad. The law review is managed and edited by an editorial board consisting of students chosen through an elaborate and gruelling process. Further, an eminent advisory panel consisting of renowned lawyers, jurists and academics offers patronage to the law review in the form of constructive advice and guidance. However, the publication is truly defined in character by its profile as a law review run entirely by students and dedicated solely to student writings. This, I strongly feel, is a screaming revelation of the student enterprise, intellectualism and participation that has come to be associated with the recent reform of legal education in India.

One of the greatest hallmarks of an educational institution is its contribution to the cultivation of individual thought. The true value of any university is thus characterised by its ability to develop a culture of research to articulate such thought, and thus strengthen the vast body of academia and further expand its contours. The NSLR is symbolic of this very culture that is slowly coming to define the body and spirit of Indian legal education. Its commitment to pluralism in ideas is reflected in its selection of legal writings that span across different disciplines within the law. Further, what sets the NSLR apart from most other publications is its passionate belief in the importance of inter-disciplinarity in pedagogy. This is evidenced by the NSLR's partiality towards legal scholarship on a wide array of issues that merits an analysis of the law in the context of other disciplines. Hence, do not be surprised when in this year's volume, you come across a motley of issues as diverse as constitutionalism, corporate governance, taxation, labour policy and intellectual property touching upon disciplines as varied as economics, religion, political science and commerce.

With these words, on behalf of the Board of Editors, it gives me great pleasure in introducing you to Volume 7 (2012) of the NSLR. I have no doubt that this year's issue will live up to its established standards and prove to be of immense value for students, academics, practitioners and jurists both within India and outside. We look forward to your continued support and readership along with any constructive feedback to help the NSLR scale the heights as a definitive symbol of exemplary legal scholarship.



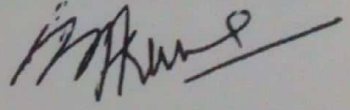
Prof. (Dr.) Faizan Mustafa

From the Faculty Advisor

It is indeed a matter of great pride to see our Nalsar Student Law Review launching its 7th issue. This issue brings to the fore rich scholastic and academic writing by the student fraternity. The present issue has been conceived and compiled by the NSLR editorial board in such a way that it touches all the important and latest developments in the legal field today. Abhinav Sekhri's article makes for a good academic reading on the evolution of the law of bias in India. While Arushi Garg makes interesting comparisons with respect to secularism in India and Israel, Pallavi Arora examines the working of the flexicurity model and its successful implementation in Denmark as a possible alternative in India. Anshuman Shukla, questions whether man deserves an improvised death and if yes, whether this is a moral entitlement of the State or society. Navajyoti Samanta's article touches upon issues of corporate governance while Scott James Myer launches a criticism of public international law based on the principles of indvidualism. Sanjhi Jain and Nishant Sharma examine important questions of taxation law which are bound to have a significant repurcussion on the Indian economy.

Student law reviews are characteristic of all law schools and represent a significant milestone in the academic growth of an educational institution. It is important for us to know what good laws ought to be like and hence, everyone who has ideas about them should express the same. Therefore, the NSLR has been put together by our young and brilliant NALSAR students as a platform to bring to our attention some interesting thoughts on various legal issues. However, the NSLR has also been instrumental in developing a culture on campus where students are motivated and nurtured to think about important issues. The NSLR has been active in organising panel discussions on various contemproary issues, legal writing workshops and national level competitions such as the Ashurst-NSLR contract drafting competition and the legal writing competition. These opportunities provide students with the impetus to develop their skills of legal analysis and writing and promote the role of legal scholarship as an integral part of the "law school experience".

We thank and commend the contributors to Vol. 7 whose insightful articles provide a multi-dimensional viewpoint to various aspects of law. Such a law review deserves the best of an academic environment for it to grow and flourish. We wish the NSLR the very best.



Prof. Aruna Venkat

EDITORIAL

The human condition is woven in the fabric of justice as a motif of differing patterns. Every pattern is emblematic of the subjective realities and multiple truths that come to define the unique existence of every person. Each individual has a unique perception of the world, of *ideas* and of the truth that forms an individual sense of reality different from the rest. The human condition is thus enriched by its own diversity arising from a multiplicity of beliefs. However, it is also regulated by the instrumentality of law in the *interests* of justice, to reconcile differing versions of the truth, and in some rare cases allowing for co-existence. The law thus influences, amends; and sometimes, distorts these very patterns. The *idea* of justice then, in one way, is to provide a *space* to question, to express, to assert, to criticize, to investigate, to articulate, to rebuke, to inquire and to *question* that very law which affects the human condition.

The Nalsar Student Law Review is a metaphor for this very *space* where diverse legal issues of contemporary importance are critiqued in form and substance. It is an enabling platform for the burgeoning student talent to express its study of the law through the art of legal writing. Strengthened by such convictions, Vol. 7 brings to fore nine pieces of exemplary legal scholarship from students in India and abroad. The articles, essays, notes and case comments in this volume focus on some important legal developments that arose during 2011-12 along with certain contemporary issues, which retain extreme significance for the socio-politico-legal landscape of India and the world.

Abhinav Sekhri's case comment examines the Supreme Court's decision in *Justice P D Dinakaran v. Hon'ble Judges Inquiry Committee* in the context of the law on bias and attempts to sketch the Indian experience. The comment is an engaging attempt to ascertain the Indian position on the law on bias distinct from common law standards and its implications in the Indian context.

Arushi Garg's piece makes a detailed comparison of judicial attitudes towards secularism in India and Israel concluding that both the judiciaries have adopted vastly different approaches to questions of religious neutrality. She undertakes an interesting exercise to identify the factors responsible for a judiciary that is progressive and fearless of the prevailing political agenda on the one hand and a judiciary that is seemingly influenced by religion on the other.

Pallavi Arora's article demands that the policy of flexicurity (based on an ideal combination of flexibility for the employer and security for the employee) informs labour policy in India. She makes a compelling case for the flexicurity model to be imported into the Indian labour market rendered inflexible due to an array of rigid labour laws.

Anirudh Chandrashekhar's case comment on *Tea Board India v. ITC Limited* analyses the first ever decision by an Indian court on the infraction of a geographical indication. The comment, grounded in an understanding of the concept of geographical indications as an intellectual property right examines the decision in light of the scope and limitations of the protection afforded to a geographical indication under Indian law.

Anshuman Shukla's profound essay makes a philosophical inquiry into the notion of death penalty from a Kantian paradigm. By taking recourse to Albert Camus' essay on the rejection of death penalty, he highlights the inadequacies in Kant's justification of the death penalty.

Navajyoti Samata, in his article, examines the Anglo-American jurisprudence on corporate governance. He examines various models such as non-executive directors, performance related pay for executives and markets for corporate control before suggesting that the stakeholder welfare regime should be the chosen method to ensure corporate responsibility.

A passionate defence of individualism against the notion of collectivism, Scott James Myer's compelling essay brings home ideas from the Austrian School of Economics to critique public international law with a special focus on human rights and education. In a spirited exposition of the principles of Anarcho-Capitalism, he puts forth a libertarian conception of international law.

In a comprehensive note, Sanjhi Jain explores the debate around the anti-tax avoidance measures against controlled foreign corporations and their implications for India. Through her note, she critically analyses provisions of the Direct Taxes Code, 2010 and suggests several amendments in the context of the Indian economy.

Nishant Prasad's contemporaneous case comment analyses the recent judgment of the Supreme Court in the *Vodafone* case. In doing so, he foregrounds the analysis in the context of the debate between tax planning and tax evasion drawing from the experiences of foreign jurisdictions.

It has been our endeavour to treat these pieces of legal scholarship in a manner that offers obeisance to the original intent, ideas and thoughts of the authors. Vol. 7 is a fascinating issue that jumps across disciplines, subjects and laws- all unified in their quest to realise the *idea* of justice through the instrumentality of academia. We hope you enjoy the issue and look forward to your continued patronage.

Board of Editors, 2011-12

Lost In Translation: India And The Real Likelihood Standard

*Abhinav Sekhri**

Abstract

Nemo debet esse judex in causa proporia sua (no person can be a judge in her own cause) is a touchstone of the principles of natural justice and a useful tool to maintain fairness in adjudication across legal systems. It is a trite proposition that not all bias can be eliminated, and thus this principle has seen the development of different standards over time in common law since the turn of last century. The Supreme Court recently engaged in an insightful discussion on the issue in *Justice P.D. Dinakaran v. Hon'ble Judges Inquiry Committee*[1] and the decision merits greater consideration. The first part of the essay charts out the development of the law on bias in England and India. This provides valuable context for the discussion of the judgment itself. Through this decision, the essay attempts to answer some vexing questions about the Indian experience with the law on bias, and also about the road ahead. It has been argued that the Indian approach must not be contradistinguished with common law, for there is a difference regarding how standards are used to indicate the degree and viewpoint in questions of bias. There is an Indian approach, thus mention of the observer standard does not automatically signal concurrence with common law.

Introduction

The impossibility of establishing actual bias in the mind of the decision-maker has been an accepted reality since the 19th century.[2] Professor De Smith in his now hallowed treatise has etched out three cardinal requirements of public law, which have determined how the law on judicial bias has developed through time. *First*, there is the requirement for accuracy in public decision making; *second,* the need for absence of any prejudice on part of the decision-maker; and *third* the requirement for the decision-making process to retain public confidence.[3] Today, it is accepted that there exist three kinds of bias attributable to the decision-maker: pecuniary, personal and official. The first results in automatic disqualification and the remaining do not,[4] but require further inquiry by the judicial mind with deference to the above-mentioned requirements.

* IV Year, B.A. LL.B. (Hons.). National Law School of India University, Bangalore. The Author would like the thank Mr. Shantanu Naravane for his comments on the initial draft, and the Board of Editors for their assistance throughout the editing process.

1 (2011) 8 SCC 380 [hereinafter *Dinakaran*].

2 Dimes v. Grand Junction Canal, (1852) 3 HLC 759 [hereinafter *Dimes*].

3 De Smith, Woolf & Jowell, Judicial Review of Administrative Action 521 (5th ed.1995).

4 *See*, R v. Bow Street Metropolitan Stipendiary Magistrate, *ex parte* Pinochet Ugarte (No 2), 1999 All ER 577. In this decision, the House of Lords famously held a judgment on account of personal bias to be hit by automatic disqualification.

Such an inquiry was required by the Division Bench in *Dinakaran*, and the judgment delivered by the Apex Court forms the basis of this essay. The decision provides the most comprehensive discussion taken up by the Apex Court on the question of bias, with the Division Bench covering not only Indian case law but also common law decisions. Beyond the discussion, the judgment is particularly relevant for it changes the law in India relating to the question of bias. Confirming the application of the "real likelihood" test,[5] Justice Singhvi, has added that the "Court has to consider whether a fair minded and informed person, having considered all the facts would reasonably apprehend that the Judge would not act impartially."[6] What exactly is this "real likelihood" the Court alluded to? Who is this "fair-minded and informed observer"? These questions have been discussed by the Court in *Dinakaran* and this essay will shed greater light on the same. But, before analysing the decision it is important to have a theoretical understanding of the law on bias. In the first part, I aim to provide that base, elaborating upon the development of the law abroad and in India. Thereafter, I move to a detailed comment on the decision, and attempt to answer some pointed questions regarding the nature of standards in India in the aftermath of *Dinakaran*.

I. England and the Question of Bias

The roots of the famous principle, that justice must appear to be done, can be traced to the famous case of *Dimes* v. *Grand Junction Canal*,[7] where Lord Campbell emphasised that the idea "should be held sacred".[8] The more famous affirmation of this maxim came with Lord Hewart, C.J. in *R* v. *Sussex Justices ex parte McCarthy*,[9] where he famously said that "… justice should not only be done, but should manifestly and undoubtedly be seen to be done".[10]

In the early stages, the "real likelihood" test emerged as one of the most popular tools for the judiciary to decide questions of bias. It required proving that there was a *probability* as against mere *possibility* of bias,[11] and the facts were assessed from the perspective of the the Court and not from the eyes of a reasonable man.[12] Justice Blackburn, was

5 *Dinakaran*, *supra* note 1, at ¶ 43 (Singhvi, J.).

6 *Dinakaran*, *supra* note 1, ¶ 43 (Singhvi, J.).

7 *Dimes*, *supra* note 2 . Allegations of pecuniary bias were leveled against Lord Cottenham, L.C. regarding several decrees affirmed by him involving the respondent company, for he owned substantial shares of the same. The House of Lords famously set aside the decrees, stressing the need to secure the appearance of justice in the eyes of the public.

8 *Dimes*, *supra* note 2, at 793 (Campbell, L.J.).

9 R v. Sussex Justices, *ex parte* McCarthy, [1924] 1 KB 256 [hereinafter *McCarthy*]. A solicitor was representing a client suing a motorist for damages from a collision, and was also acting clerk for the justices before whom the matter was heard. The s olicitor retired with the justices when they retired to their chambers for consideration, and ultimately convicted the motorist. Lord Hewart, C.J. believed the solicitor's presence at the time of consideration invalidated the decision on grounds of bias.

10 *McCarthy*, *supra* note 9, at 259.

11 Peter Leyland & Gordon Anthony, Textbook on Administrative Law 380 (6th ed. 2009).

12 H.W.R Wade & C.F. Forsyth, Administrative Law 464 (9th ed. 2005).

perhaps the first who employed this test, while facing an issue of judicial bias in *R* v. *Rand*.[13] The learned Justice said, "Wherever there is a real likelihood that the judge would, from kindred or any other cause, have a bias in favour of one of the parties, it would be very wrong in him to act…."[14] Subsequently, the House of Lords also endorsed this standard in *Frome United Breweries Co.* v. *Bath Justices*.[15]

As against this, there was the "reasonable suspicion" test, which had its foundations in the idea that justice must be seen to be done and thus assessed facts from the viewpoint of a member of the public. Lord Hewart subscribed to this school of thought, and said that "[N]othing is to be done which creates even a suspicion that there has been an improper interference with the course of justice."[16] Professor Wade notes that the difference between the two tests was not marked during the first half of the 20th century, and they were used to arrive at the same conclusion.[17] However, the observations in *R* v. *Camborne Justices*[18] provide proof of a widening gap.[19] This gap was supplemented by a growing confusion regarding the nature of the tests, and the decision in *R* v. *Barnsley Licensing Justices*[20] reflected both. Devlin, L.J. equated "likelihood" with "probabilities" which seemed a throwback to the times of *Rand* when actual bias was what the judges were looking for. Thus, two points of distinction between the tests could be observed:

13 (1866) LR 1 (Q.B.D.) 230 [hereinafter *Rand*]. The question before the Queen's Bench was whether two justices having some financial links to the Bradford Corporation ought to have been disqualified from the proceedings where a decision favourable to the Corporation was delivered. Answering in the negative, Blackburn, J. used the "real likelihood" standard and emphasised the divergent practice between issues of pecuniary and other forms of bias.

14 *Rand*, *supra* note 13, at 232-33 (Blackburn, J.).

15 Frome United Breweries Co. Ltd. v. Keepers of the Peace and Justices for County Borough of Bath, [1926] AC 586 [hereinafter, *Bath Justices*]. The licensing justices of Bath borough were also members of the compensation authority. An application was made to the justices for renewal of certain old on-licenses, including that of one Seven Dials Hotel, which was referred to the compensation authority. At a further meeting, the justices resolved that a solicitor should be instructed to oppose the renewals of licenses so referred. The solicitor duly appeared and opposed the renewals, which was opposed. The justices present at this meeting included three justices who had given instructions to the solicitor to oppose renewals. The House of Lords held quashed the decision, stating that the justices were disqualified from sitting on the compensation authority on grounds of bias.

16 *McCarthy*, *supra* note 9, at 259 (Hewart, C.J.).

17 Wade & Forsyth, *supra* note 12, at 465.

18 R v. Camborne Justices *ex parte* Pearce, (1955) 1 QB 41.

19 It was observed: [the] Court feels that the continued citation of [the dictum of *McCarthy*] in cases to which it is not applicable may lead to the erroneous impression that it is more important that justice should appear to be done than that it should in fact be done. *R* v. *Camborne* Justices, *supra* note 18, at 52 (Slade, J.).

20 R v. Barnsley Licensing Justices, *ex parte* Barnsley and District Licensed Victualler's Association [1960] 2 QB 167 [hereinafter, *Barnsley*].Upholding the lower court decision by Salmon, J. the Court observed: I am not quite sure what test Salmon, J. applied. If he applied the test based on the principle that justice must not only be done but manifestly seen to be done, I think he came to the right conclusion on that test. … But in my judgment that is not the test … We have not to inquire what impression might be left on the minds of … the public generally. We have to satisfy ourselves that there was a real likelihood of bias – not merely satisfy ourselves that that was the sort of impression that might reasonably get abroad. *Barnsley*, at 186-87 (Devlin, L.J.).

first, the "reasonable suspicion" standard was on a higher plane as compared to the "likelihood" test for it relied on the views of the *reasonable man* as against the judges themselves. *Second*, the former did not require establishing "probabilities" of bias and thus had a lower evidential burden as compared to the "real likelihood" test.[21]

In spite of attempts such as *Barnsley* to mark out the difference between the tests, confusion as to their application remained. Were the tests actually *different* or just different names for the same ideas? Since the irrelevance of establishing actual bias had become almost a truism since *McCarthy*, the distinction between the tests for many was really one of viewpoint alone. In hindsight, it appears that sustaining two tests only this basis was akin to hair-splitting exercises, the likelihood of the court differing from the opinion of a reasonable man where the latter arrives at a conclusion that there was an apprehension of bias being negligible to consider.[22] Perhaps driven by the same belief, Lord Denning, M.R. in *Metropolitan Properties* v. *Lannon*[23] consciously reinterpreted the "real likelihood" standard in a manner contrary to *Barnsley* by stressing on the appearance of bias again.[24] But, he did not discuss whether there were different standards at play, and thus the controversy did not cease. *Lannon* resulted in a *"somewhat confusing welter of authority"*[25] and it became unclear as to whether there where different tests, and if so what was the difference between them, which made the decisiveness of the test exceedingly rare.[26]

In *R* v. *Gough*[27] the Lords moved away from the confusion surrounding the two tests and adopted a variant of the "real likelihood" standard in the "real danger" test,[28] which had been employed by courts on a few previous occasions as well.[29] The "real danger" test adopted the viewpoint of the Court, but focused on possibility rather than probabilities of bias. A discussion of the nuances would be tangential, and the test is only relevant for this discussion as the problems perceived to be associated with it paved the way for the "fair minded and informed observer" standard to occupy the field today.

21 Leyland & Anthony, *supra* note 11.

22 Paul Jackson, *A Welter of Authority,* 34 (4) Mod.L.R. 445, 446 (1971).

23 [1969] 1 Q.B [hereinafter *Lannon*] A Rent Assessment Committee was called for determining fair rental rates for a block of housing apartments in London, The rent so determined was substantially below the rentsuggested by an independent expert called by the tenants and thus the landlord sought to quash the decision of the Committee on grounds that the chairman was a solicitor who had earlier handled a similar matter for tenants in another block of flats. The Court of Appeal held that the facts gave rise to an appearance of bias and thus quashed the decision of the Committee, even in absence of any actual bias on his part.

24 In considering whether there was a real likelihood of bias the court does not … look to see if there was a real likelihood that he would or did in fact favour one side at the expense of the other. The court looks at the impression, which would be given to other people the reason, is plain enough. Justice must be rooted in confidence: and confidence is destroyed when right-minded people go away thinking: 'The judge was biased' [sic]. *Lannon*, *supra* note 22, at 599 (Denning, M.R.).

25 Hannam v. Bradford C.C, [1970] 1 WLR 937, at 945 (Widgery, L.J.)

26 *See*, R v. Gough, [1993] AC 616, at 661, (Goff, L.J.).

27 R v. Gough, [1993] AC 616 [hereinafter *Gough*].

28 *Gough*, *supra* note 27, at 670 (Goff, L.J.).

29 R v. Spencer, [1986] 2 All ER 928; R v. Smails, [1987] AC 128.

The "real danger" test was criticised heavily by the Court of Appeal, which understood it as searching for actual bias.[30] This perception was to spell greater trouble, when the Human Rights Act was passed in 1998, providing domestic remedies for breach of the European Convention on Human Rights.[31] Since Article 6 (1) of the Convention insisted on "appearance" of bias as the threshold requirement, maintaining a test endorsing "actual bias" would give rise to a conflict between the common law and European standards along with several domestic claims for violation of Convention rights.[32] To provide a temporary solution, guidelines were provided for the application of the test in *Locabail (UK) Ltd. v. Bayfield Properties Ltd*,[33] but it became apparent that a shift was on the horizon.

The shift occurred in *Porter* v. *Magill*,[34] where the House of Lords opted for a "modest adjustment"[35] and ushered in the "fair-minded and informed observer" as the appropriate standard.[36] The change was located as having its core in the requirement of public confidence,[37] but a more pressing consideration was the need to harmonise common law and the position followed by the Strasbourg Court, and a host of other Commonwealth countries.[38] The High Court of Justiciary in Scotland adopted a test relying upon suspicions of bias created within the eyes of the reasonable man aware of the circumstances.[39] Strasbourg adopted an 'objective test', establishing whether there was a risk of bias objectively – on a demonstrable and rational basis – in the light of the

30 R v. Inner West London Coroner, *ex parte* Dallaglio, [1994] 4 All ER 139, at 152 (Simon Brown, L.J.).

31 Human Rights Act, 1998. See, § 6(1); "It is unlawful for a public authority to act in a way which is incompatible with a Convention right".

32 Convention for the Protection of Human Rights and Fundamental Freedoms, Article 6(1), 3 Sep., 1953, C.E.T.S. 5; In the determination of his civil rights and obligations or of any criminal charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law. Judgment shall be pronounced publicly but the press and public may be excluded from all or part of the trial in the interest of morals, public order or national security in a democratic society, where the interests of juveniles or the protection of the private life of the parties so require, or to the extent strictly necessary in the opinion of the court in special circumstances where publicity would prejudice the interests of justice; [hereinafter *ECHR*]

33 [2000] QB 451, at 25 (Bingham, L.J.) [hereinafter *Locabail*]. The Court held that it could not be expected of a judge to recuse himself on grounds such as religion, ethnic or national origin, gender, age, sexual orientation and other fundamentals. Further, in normal circumstances other factors such as educational background, previous political affiliations, membership of charitable associations would also be irrelevant. However, close personal connections between the judge and a person involved in the case or previous expression of strong views of the judge about something connected to the case would be a case where a real danger of bias might arise.

34 Porter v. Magill, [2002] 2 AC 357 [hereinafter *Porter*].

35 *Id.* at 494 (Hope, L.J.). The "modest adjustment" had been sought in *In re* Medicaments and Related Classes of Goods (No 2), [2001] 1 WLR 700 and was specifically approved by the House of Lords.

36 *Porter*, *supra* note 34, at 494-96 (Hope, L.J.).

37 Lawal v. Northern Spirit Ltd., [2003] UKHL 35 [hereinafter *Lawal*]. It was observed: "The small but important shift approved in Magill v Porter has at its core the need for "the confidence which must be inspired by the courts in a democratic society [sic]". *Lawal* at 14 (Steyn, L.J.).

38 *Porter*, *supra* note 34, at 494 (Hope, L.J.).

39 Bradford v. McLeod, 1986 SLT 244.

circumstances so identified.[40] In a similar vein, courts in England now inquire "whether the fair-minded and informed observer, having considered the facts, would conclude that there was a real possibility that the tribunal was biased."[41]

The previous paragraphs provide an indication of the complicated history of the common law tests of bias, and it would be beneficial to provide a brief recap of the salient features shorn of the myriad of judicial dicta. The test of real likelihood arrived first, which established the threshold at establishing "real bias" in the eyes of the Court. This was countered with the reasonable suspicion standard, which placed a much lower threshold focusing on the appearance of bias created in the eyes of the reasonable man. While the "likelihood" test was motivated by the first two of De Smith's principles, the "suspicion" standard stemmed from the third requirement of securing public confidence. The growing popularity of the "reasonable suspicion" standard in absence of its recognition by the House of Lords promoted great confusion amongst the judiciary as to the proper standard for determining issues of bias; a feature of common law jurisprudence for the better part of the last century. The Apex Court finally intervened to resolve the confusion by the House of Lords, which introduced the "real danger" standard, assessing facts from the viewpoint of the court in line with the "real likelihood" test but only requiring the establishing of a possibility of bias as with the "reasonable suspicion" standard. Scathing criticism from the judiciary, which perceived this as a threat to Lord Hewart's hallowed dictum, led to the displacement of this test with the "fair-minded and informed observer" standard, which occupies the field today. By shifting the viewpoint from the Court to that of a "fair-minded and informed observer", without any further changes from the "real danger" test there was an explicit affirmation of the principle of apparent bias, which quelled fears of a conflict between the common law and European positions. The *observer* shall form a prominent part of this discussion in latter parts, but first, it is imperative to discuss the position of law on the question of bias in India.

II. Bias in India: From *Manak Lal* to *Dinakaran*

The question of bias was first properly considered by the Apex Court in *Manak Lal* v. *Dr. Prem Chand*,[42] a case involving an issue of personal bias. Was the decision of the Tribunal convicting the appellant of misconduct vitiated by bias on account of the Chairman having served as the lawyer for the opposite party at an earlier stage of the matter? Justice Gajendragadkar, believed so, and said "… the test always is and must be whether a litigant could reasonably apprehend that a bias attributable to a member of the tribunal might have operated against him in the final decision of the tribunal."[43] He further held that the same applies to "all tribunals and bodies which are given jurisdiction

40 Piersackv. Belgium, (1982) 5 EHRR 169; Hauschildt v. Denmark, (1989) 12 EHRR 266.

41 *Porter*, *supra* note 34, at 494-96 (Hope, L.J.)

42 AIR 1957 SC 425 [hereinafter, *ManakLal*].

43 *Manak Lal*, *supra* note 42, at ¶ 4 (Gajendragadkar, J.).

to determine judicially the rights of parties."[44] It is interesting to note that while *Manak Lal* is credited with applying the "real likelihood" test,[45] these words find no mention in the decision.[46]

Soon after the decision in *Manak Lal*, two important decisions of the Supreme Court saw determination of a "reasonable suspicion" standard of bias to set aside the decision,[47] without any explanation as to what is meant by the phrase. The Court observed: "any direct pecuniary interest, however small, in the subject-matter of inquiry will disqualify a judge, and any interest, though not pecuniary will have the same effect, if it be sufficiently substantial to create a reasonable suspicion of bias"[48]. The Court in *A.K. Kraipak* v. *Union of India*[49] was concerned with the issue of bias, and said that "a mere suspicion of bias is not sufficient, there must be a reasonable likelihood of bias"[50]; again failing to deliver the all-important explanation of these phrases.

More than a decade after *Manak Lal* and *Gullapalli*, the Apex Court went on to discuss the two tests in *S. Parthasarthi* v. *State of Andhra Pradesh*.[51] The Court had to decide whether past inimical behaviour of the inquiry officer towards the petitioner was enough to indicate bias on part of the former, making the termination order so passed by him null and void. The Court cited many English decisions on the point while deciding in favour of the appellant. However, a closer scrutiny of the relevant paragraphs reveals the confused nature of the reasoning adopted. At first, the Court observes that:

> *[t]here must be a "real likelihood" of bias and that means there must be a substantial possibility of bias* [emphasis supplied]"[52], but later contradicts itself by saying the question was "*whether a real likelihood "of bias existed is to be determined on the probabilities to be inferred from the circumstances by court objectively* …[emphasis supplied][53].

On the question of the applicable test, Justice Mathew opined that the two tests of "real likelihood" and "reasonable suspicion" were inconsistent; not mentioning any Indian decision on the point and relying heavily on *Lannon* to understand them.[54] The

44 *Id.*

45 *See, Dinakaran*, *supra* note 1.

46 While it does mention *Bath Justices* which talks about the "real likelihood" test, the paragraph of Viscount Cave, L.C. enunciating this principle is not mentioned in the judgment. *See*, *Manak Lal*, *supra* note 41, at [4] (Gajendragadkar, J.).

47 Gullapalli Nageswara Rao v. State of Andhra Pradesh, AIR 1959 SC 1376 [hereinafter *Gullapalli*]; Mineral Development Ltd. v. State of Bihar, AIR 1960 SC 468.

48 *Gullapalli*, *supra* note 47, at ¶ 6 (SubbaRao, J.).

49 A.K. Kraipak v. Union of India, AIR 1970 SC 150 [hereinafter *Kraipak*].

50 *Id.* at ¶ 15 (Hegde, J.).

51 S. Parthasarthi v. State of Andhra Pradesh, AIR 1973 SC 2701 [hereinafter *Parthasarthi*].

52 *Id.* at ¶ 13 (Mathew, J.).

53 *Id.* at ¶ 15 (Mathew, J.).

54 *Lannon*, *supra* note 23.

Court does not make any reference to how it understands the "reasonable suspicion" standard,[55] but it seems that the point of distinction for Justice Mathew was the degree to which bias is required to be established.[56] The "real likelihood" test was approved, and following Lord Denning M.R., it was held that "the reviewing authority must make a determination on the basis of the whole evidence before it, whether a reasonable man would in the circumstances infer that there is real likelihood of bias."[57]

Since *Parthasarthi* the Supreme Court has applied this version of the "real likelihood" test consistently in a variety of circumstances. Thus, the inclusion of a former witness against the appellant on an enquiry committee setup to investigate the nature of the charges against the latter was held to create a real likelihood that the findings of the committee would be biased.[58] In another case, the Court applied the *necessity* doctrine and held that the Director General of Communications could not recuse himself even though his son was the member of a company applying for operating licenses, as without him a competent authority could not be constituted.[59] The "real danger" test has very rarely been mentioned by the Apex Court,[60] and the manner in which it has been applied makes those decisions seem as anomalies rather than a shift from the old standard. The latest development in the law on bias in India has come with the judgment delivered in *Dinakaran* where another such shift has been attempted by employing the *observer* standard, and it forms the basis of the remainder of this essay.

III. The Decision in *Dinakaran*

The petitioner, P.D. Dinakaran, was the Chief Justice of the Karnataka High Court, and was cleared for elevation to the Supreme Court in 2009. Subsequently however, 50 members of the Rajya Sabha submitted a notice of motion for his removal under Articles 217 and 124(4) of the Constitution alleging several acts of misbehaviour committed by him. The notice was admitted and a Committee was constituted under Section 3 (2) of

55 It is noteworthy to quote how the "reasonable suspicion" standard was understood: "*The courts have quashed decisions on the strength of the reasonable suspicion of the party aggrieved without having made any finding that a real likelihood of bias in fact existed*". *Parthasarthi*, *supra* note 51, at ¶ 14 (Mathew, J.).

56 The Court observed: "Surmise or conjecture would not be enough. There must exist circumstances from which reasonable men would think it probable or likely that the inquiring officer will be prejudiced against the delinquent". Thus furthering the conclusion that the degree to which bias is established was the key. *Parthasarthi*, *supra* note 51, at ¶ 16 (Mathew, J.).

57 *Parthasarthi*, *supra* note 51, at ¶ 16 (Mathew, J.). The Court did not entirely disband the "reasonable suspicion" test and held it to be applicable in criminal proceedings.

58 Rattan Lal Sharma v. Managing Committee, Dr. Hari Ram (Co-Education) Higher Secondary School, AIR 1993 SC 2155.

59 Tata Cellular v. Union of India, AIR 1996 SC 11, at 153-154 (S. Mohan, J.). *See also,* Ashok Kumar Yadav v. Union of India, AIR 1987 SC 454, at 19 [hereinafter *Ashok Kumar Yadav*]. Here the Court applied the *necessity* doctrine to hold that it was enough that a member of the Haryana Public Service Commission withdrew from the selection of one of his close relatives, and did not withdraw from the entire procedure of selections.

60 Kumaon Mandal Vikas Nigam Ltd. v. Girja Shankar Pant, 2000 (7) SCALE 19 [hereinafter *Kumaon Mandal*]; State of Punjab v. V.K. Khanna, (2000) 7 SCALE 731.

the Judges (Inquiry) Act, 1968 consisting of Justice V.S. Sipurkar, of the Supreme Court, Justice A.R. Dave, of the High Court of Andhra Pradesh, and Mr. P.P. Rao. While the accused raised objections of Mr. Rao being biased against him, the Committee (without Mr. Rao) did not find merit in the contentions and arrived at a guilty verdict. Thus a petition to quash the order as null and void due to the Committee being biased was filed before the Supreme Court under Article 32.[61]

The question before the Court was straightforward: did the presence of Mr. P.P. Rao on the Inquiry Committee create a real likelihood of the Committee being biased against the Appellant, due to Mr. Rao's outspoken criticism of the Appellant? The question, as per Justice Singhvi was to be considered from the viewpoint of a "fair-minded and informed observer". Various High Courts across the country began to adopt this standard after its inception in the U.K.,[62] but this was the first occasion when the same was employed by the Apex Court. After subjecting the facts to such an inquiry, the Court believed that the presence of Mr. Rao did create a reasonable apprehension of bias in the minds of such a person.[63]

The portion of the decision discussing the question of bias first considers English decisions, and then moves on to decisions by Indian courts. Justice Singhvi has undertaken a thorough analysis of English decisions, starting from *Rand* itself.[64] He proceeds to discuss *McCarthy* without mentioning *Bath Justices* and notably fails to mention the important decision in *Barnsley* before making a one line reference to *Lannon*.[65] Nevertheless, the Hon'ble Justice appears to have correctly understood the difference between the two standards of "real likelihood" and "reasonable suspicion", something that had not been provided thus far by the Apex Court:

> *Many judges have laid down and applied the 'real likelihood' formula, holding that the test for disqualification is whether the facts, as assessed by the court, give rise to a real likelihood of bias. Other judges have employed a 'reasonable suspicion' test, emphasizing that justice must be seen to be done, and that no person should adjudicate in any way if it might reasonably be thought that he ought not to act because of some personal interest.*[66]
> (Emphasis supplied)

The Court goes on to discuss the important development in *Gough*, but provides a rather perfunctory analysis when it says that the "real likelihood" test was applied by

61 *Dinakaran*, *supra* note 1, at 1-12 (Singhvi, J.).
62 Sridhar Lime Products v. Deputy Commissioner of Commercial Taxes, No.II Division, [2006] 147 STC 89 (AP).
63 The Court however held that the plea although material could not be accepted due to the waiver of the same by the Appellant. *See*, *Dinakaran*, *supra* note 1, at 51 (Singhvi, J.).
64 *Dinakaran*, *supra* note 1, at ¶ 27 (Singhvi J.).
65 *Dinakaran*, *supra* note 1, at ¶ 30 (Singhvi J.).
66 *Dinakaran*, *supra* note 1, at ¶ 34 (Singhvi J.).

using "real danger",[67] and fails to mention anything about the controversy in England following the development of the "real danger" test. Rather, there is a lengthy and, in my opinion, unnecessary reference to *R* v. *Bow Street Metropolitan Stipendiary Magistrate, ex parte Pinochet Ugarte (No 2)*,[68] a landmark decision but in a different field altogether. Sadly, the learned Justice makes a grave omission when he completely fails to mention the developments post "real danger" in England with *Lawal* and *Porter*. However, he does quote from Halsbury's Laws of England later on,[69] and significantly goes on to say "[I]n each case, the Court has to consider whether a fair minded and informed person, having considered all the facts would reasonably apprehend that the Judge would not act impartially."[70] This is perhaps the most important observation on the issue of bias, for this is the first mention of the "fair-minded and informed observer" standard by the Supreme Court, albeit almost after a decade since its inception.

The decision in *Dinakaran* undertakes a vast survey of the Indian case-law, and there are no such stark omissions as observed in the common law discussion. Justice Singhvi, makes references to important decisions such as *G. Sarana* v. *University of Lucknow*,[71] and *Ranjit Thakur* v. *Union of India*,[72] but he does not observe any High Court decisions previously adopting the *observer* standard. The problems in the discussion are not of breadth, but depth and conceptual clarity; something which plagues almost every attempt at discussing the question of bias made by the Apex Court since *Manak Lal*. In hindsight, perhaps a specific mention of the standard applied therein by Justice Gajendragadkar, could have prevented some of the confusion, which followed, as observed in the previous part with the decisions in *Gullapalli* and *Parthasarthi*. The attempt at clarifying the law by Justice Mathew, relying on *Lannon* and wholly ignoring *Barnsley* was bound to be wanting, and the absence of any discussion of Indian cases leaves the decision in *Parthasarthi* all the more weak. However, unlike *Lannon* this was a decision of the Apex Court, and thus in spite of the grave failings its impact was immense and thus India did not witness any further controversy about the test for bias.

While a lot of ground is covered in terms of precedent, Justice Singhvi, fails to correct the mistakes made along the path. At one place the learned Justice refers to the interpretation classically (and correctly) made of the "real likelihood" and "reasonable suspicion" standards,[73] but subsequently observes that *Parthasarthi* applied the "real likelihood" test,[74] a good indicator of how lasting has been the effect of that dictum. A

67 *Dinakaran*, *supra* note 1, at ¶ 31(Singhvi J.).
68 1999 All ER 577.
69 *Dinakaran*, *supra* note 1, at ¶ 44 (Singhvi, J.).
70 *Dinakaran*, *supra* note 1, at ¶ 43 (Singhvi, J.).
71 AIR 1976 SC 2428.
72 AIR 1987 SC 2386.
73 *Dinakaran*, *supra* note 1, at ¶ 34 (Singhvi, J.).
74 *Dinakaran*, *supra* note 1, at ¶ 37 (Singhvi, J.).

more disconcerting note is struck when the learned Justice moves on to combine all the tests present in one idea:

> *To disqualify a person from adjudicating on the ground of interest in the subject matter of lis, the test of real likelihood of the bias is to be applied. In other words, one has to enquire as to whether there is real danger of bias on the part of the person against whom such apprehension is expressed in the sense that he might favour or disfavour a party. In each case, the Court has to consider whether a fair minded and informed person, having considered all the facts would reasonably apprehend that the Judge would not act impartially.*[75] (Emphasis supplied)

As discussed before, the *observer* emerged as a response to the criticisms of the "real danger" standard, which was seen to require proof of actual bias, and thus went against Article 6 of the ECHR. Justice Singhvi, interprets the standards differently, somewhat reflective of the difficulty faced by common law judges before *Gough* in distinguishing between the different tests. Thus, even though the Supreme Court has approved of the *observer* being imported to India it is quite difficult to fathom the manner in which the same will be employed by the courts. This difficulty is something I attempt to address in the following section, along with some observations about the importance of the latest adoption of English standards by the Apex Court.

IV. Identifying an Indian Approach

The manner in which the Supreme Court has handled the common law standards of bias can leave the impression that there is a grave lacunae not quite addressed. I disagree, and believe the flaw exists in attempting to position Indian jurisprudence solely in terms of how the developments occurred abroad. It is argued that no test *per se* is applied in India by the Court while deciding cases of apparent bias, and the usage of the phrases "reasonable suspicion" and "real likelihood" has not been in the same vein as in common law. It is no surprise therefore that Indian jurisprudence on this area appears particularly confusing if one juxtaposes it with the common law concepts. Common law believed the "reasonable suspicion" test was based on possibility being created in the minds of reasonable men whereas the "real likelihood" test was based on probabilities of bias to be determined by the court[76] thus indicating the *degree* of bias to be established *and* the *viewpoint* from which facts would be considered.[77] This was also apparent in *Gough* where Lord Goff espoused a "real danger" standard, which specified the *viewpoint* was that of the Court, and the *degree* was of possibilities rather than probabilities.[78]

75 *Dinakaran*, *supra* note 1, at 43 (Singhvi, J.).

76 De Smith, Woolf & Jowell, *supra* note 3, at 527.

77 The degree and viewpoint classification has been adopted from P.P. Craig, Administrative Law 462 (5th ed. 2003).

78 Lord Goff was at pains to elaborate both limbs of the test for determining bias, and thus while he approved of the "real likelihood" standard considering the viewpoint of the Court as against the reasonable

The Supreme Court on the other hand, used these terms as *only* determinative of the degree to which an apprehension of bias must be proven, with the inherent assumption in all judgments being that the viewpoint is not that of the Court but of an independent third party. The description of *Manak Lal* as following the "real likelihood" standard is indicative of the same. The difficulties with *Parthasarthi* also appear to be obviated to some extent if we scrutinise it with this lens, as both tests were also explained in terms of the degree of apprehension caused in the mind of the reasonable man.[79] In *Kraipak* "… mere suspicion of bias is not sufficient. There must be a real likelihood of bias"[80] is what Justice Hegde, stated, illustrative of the lines on which the different tests were understood. "The question is not whether the judge is actually biased or in fact decides partially, but whether there is a real likelihood of bias"[81] is how the test was used by the Court in *Ashok Kumar Yadav*. The most recent decision available at the time of writing this essay, *State of Punjab* v. *Davinder Pal Singh Bhullar*,[82] is also indicative of this dualism.[83] Further, the specific reference of the Court to the "real danger" test was "whether a mere apprehension of bias or there being a real danger of bias"[84], supporting the argument of a common underlying theme of a singular focus on the *degree* of bias.

As mentioned before, the debate on the *degree* of bias ceased with the "real danger" test endorsing the level of possibility as against probabilities of bias, however it remains the most important determinant for the Court. It is because of this emphasis on the *degree* of bias that the introduction of the "fair and informed observer" standard in India bears great importance, for this test is solely concerned with the *viewpoint* from which bias must be ascertained. It represents the first development on the second prong of *viewpoint* from the classical reasonable man to a more nuanced characterization of the same in the Indian context. Let us return to the paragraph where Justice Singhvi, proceeds to lay down the test for bias and converged the three standards for the same.[85] Once placed within the dual framework of *degree* and *viewpoint*, it becomes clear that it is not another instance of the Court being lost in translation when borrowing from common law. "Real likelihood" and "real danger" are phrases used to indicate the *degree* to which bias must be established and further *in each case*, the Court must consider the situation

man, he was at pains to make clear that the degree to which bias must be established was at subjective possibilities rather than the arduous level of probabilities of level as held in *Barnsley*, and thus stated the test in terms of "real danger" rather than "likelihood". *Gough*, *supra* note 27, at 670 (Goff, L.J.).

79 *Parthasarthi*, *supra* note 51, at ¶ 13 (Mathew, J.).

80 *Kraipak*, *supra* note 49, at ¶ 15 (Hegde, J.).

81 *Ashok Kumar Yadav*, *supra* note 59, at ¶ 17 (Bhagwati, J).

82 2011 (3) SCALE 394 [hereinafter *Davinder Pal Singh*].

83 *Davinder Pal Singh*, *supra* note 82, at ¶ 19 (Chauhan, J.). The Division Bench while giving its interpretation of *Dinakaran* observes: …to disqualify a person as a Judge, the test of real likelihood of bias, i.e. real danger is to be applied, considering whether a fair minded and informed person, apprised of all the facts, would have a serious apprehension of bias.

84 *Kumaon Mandal*, *supra* note 60, at ¶ 29 (Banerjee, J.).

85 *Dinakaran*, *supra* note 1, at ¶ 43 (Singhvi, J).

from the perspective of "fair minded and informed observer" rather than the reasonable man. Unintentionally, the Court has provided perhaps the clearest elucidation of the Indian approach to deciding questions of apparent bias.

V. Concurrence of Opinion: What Does the Future Hold?

The counterintuitive response to the argument so made would be that since the Indian position had always been focused on considering facts from a reasonable man's perspective, this standard merely seeks to represent the same position with another confusing phrase. This brings me to the *second* level of analysis: the consequences of importing this standard. It is conceded that this standard *can* most certainly end up being merely a complicated way of recognising a longstanding principle, but this *cannot* be presumed. The standard envisions a fair minded *and informed* observer, and this gives the scope to move much beyond the traditional leanings of the reasonable man standard. This particular trait of the observer has allowed courts abroad to impute great levels of procedural and technical detail on the observer,[86] which seems to affirm the prognosis of Wade and Forsyth of the imposition of more exacting standards regarding bias.[87]

I believe that the adoption of the *informed* observer and concurrence with the common law is not a cause for celebration but one for great reflection. This note of caution is issued as the "fair minded and informed observer" can militate against the principle identified as a cornerstone of the Indian system: consideration of facts from the perspective of the reasonable man. If applied correctly, the standard does allow for a reinforcement of the longstanding principle. However, experiences of other systems with the "fair-minded and informed observer" make it seem that the possibility of the opposite is more than likely to be realised. It is important therefore to shed greater light on the experience of the U.K. with the *observer* since its inception.

At the cost of repetition, it should be mentioned that the *observer* standard at common law consists of two aspects: the consideration of facts by a "fair-minded and informed observer" and upon such consideration, this observer harbouring "reasonable apprehensions" of bias. At the first level, the trait of the observer as *informed* is what differentiates it from any ordinary reasonable man of the public. Unfortunately, this has resulted in the "… combined wisdom of global common law jurisprudence on the "informed observer" [producing] an extraordinary and wholly unrealistic creature…."[88] A brief enumeration of the characteristics of the observer has been provided by Olowofoyeku:

> *The informed observer is reasonable, right-minded, thoughtful, not necessarily a man nor necessarily of European ethnicity or other majority traits, neither complacent nor unduly*

86 Simon Atrill, *"Fair-Minded and Informed Observer"? Bias after Magill,* 62(2) C.L.J. 279, 280 (Jul., 2003).

87 Wade & Forsyth, *supra* note 12, at 467.

88 Abimbola A. Olowofoyeku, *Bias and the Informed Observer: a Call for a Return to Gough,* 68(2) C.L.J. 388, 393 (2009). The author argues for a return to the "real danger" test so developed in *Gough.*

> *sensitive or suspicious, not unduly compliant or naïve, not entitled to make snap judgments, and would not reach a hasty conclusion based on the appearance evoked by an isolated episode of temper or remarks to the parties or their representatives, which was taken out of context. He or she does not have a very sensitive or scrupulous conscience, can be expected to be aware of the legal traditions and culture, but may not be wholly uncritical of this culture, and would adopt a balanced approach.*[89] (References omitted)

Such unrealistic creations of what the observer might be have a direct impact on the second limb of the standard: of there being a "reasonable" apprehension of bias being created in the mind of the *observer*. The fear that the pendulum had swung too far in the direction of establishing actual bias prompted the House of Lords to supplant the "real danger" test with the *observer*. Providing the *observer* with different qualities each time unfortunately seems to have pushed that metaphorical pendulum far in the opposite direction, impinging the credibility of "reasonable" apprehensions being created.[90] The *observer* becomes what the Court wills it to be, defeating the very purpose of considering the view of someone outside the court.[91] Thus, while the intention was to move away from *Gough*, the law is surprisingly moving closer to the same.[92]

Simon Atrill has argued that the manner in which the *observer* has been applied reflects an abrogation of the policy interests responsible for the introduction of the *observer* in the first place.[93] The test itself is not valuable, and only a means or instrument to attain the greater objective of ensuring public confidence in the system.[94] Beyond this major aim of ensuring confidence of the public, in light of Article 6 (1) entering the fray many other interests also become involved, aiming to protect "non-instrumental" values such as the dignity of the individual pleading bias.[95] The Courts rarely appreciate these interests at play, and seem to consider the test as "self-executing". The second level of the problem exists in the form of other interests getting affected in attempts to further such policy interests, something considered irrelevant[96] or not discussed by cases at all.

---

89 Olowofoyeku, *supra* note 88, at 394-95. For further illustrations of this argument, *see*, Olowofoyeku, *supra* note 88, at 401-405.

90 Olowofoyeku, *supra* note 88, at 396.

91 Olowofoyeku, *supra* note 88, at 396.

92 It was observed: Furthermore, I think it unnecessary, in formulating the appropriate test, to require that the court should look at the matter through the eyes of a reasonable man, *because the court in cases such as these personifies the reasonable man*; and in any event the court has first to ascertain the relevant circumstances from the available evidence, knowledge of which would not necessarily be available evidence, *knowledge of which would not necessarily be available to an observer in court at the relevant time.* (Emphasis supplied) *Gough*, *supra* note 27, at 670 (Goff, L.J.).

93 Atrill, *supra* note 86, at 283.

94 Atrill, *supra* note 86, at 283.

95 Atrill, *supra* note 86, at 283.

96 R v. Mason, [2002] EWCA Crim 385, at [32]-[33] (Lord Woolf, C.J.). Allegations of bias were levelled against the judge for he knew the Chief Constable who was a witness for the prosecution, something he admitted during course of the trial. While Lord Woolf, C.J. accepted this was an "almost inevitable consequence"

They impose great costs on the system, such as the presence of a stricter test leading to increased rates of recusal, which would further affect the efficiency of the system by increasing the time for trials for one.[97] It is because of the reasons alluded to above that the High Court of Australia in *Johnson v. Johnson*,[98] and the Court of Appeal in Northern Ireland in *In Re Purcell's Application*[99] have expressed reservations about this standard.

The problem associated with making arguments based on experiences abroad is the peculiar manner in which standards of bias have been applied by Indian Courts. After observing the usage of the "real likelihood" standard, there is a strong case to be made against the correct application of the "fair minded and informed observer". If one was to indulge in the dangerous game of predictions, given the manner of past usage as well as there being no discussion on the nature of the observer in *Dinakaran*, I believe that the scales are tipped in favour of the test being understood as a mere phrase reaffirming the traditional "reasonable man" perspective. The usage of the test in *Dinakaran* leaves the question largely open, but provides some support for my claims.[100] After realising the nature of problems that a proper understanding of the standard brings, perhaps such an interpretation would yield more good than harm for the system.

VI. Conclusion

This essay attempted to bring to light the important contributions made by the decision in *Dinakaran* to the jurisprudence on standards of bias in India, and critically analyse the same. The detailed study undertaken in the decision deserves accolades, and is the first of its kind since the effort made by Justice Mathew, in 1973. While the scope of analysis is quite pervasive, it is similar to its predecessors and lacks depth. The different nature of standards of bias so developed at common law seems to escape the Court, and the import of the "fair-minded and informed observer" does not do much to resolve the conflict clear upon juxtaposing the two jurisdictions' developments.

At first blush, the dicta on judicial bias appears another instance of the disconcerting practice of transplanting legal doctrines present abroad in the Indian milieu without fully appreciating the import of the same. I argued otherwise, and believe that this act of juxtaposing is a path down a blind alley. Tracing the development of law since the

---

of the trial taking place before a local judge, he believed "questions of convenience" could not determine the issues. He completely ignored the possible costs which would arise if every judge had to recuse in such or similar circumstances.

97 Atrill, *supra* note 86, at 284. Atrill thus proposes a new model, focusing on the balancing of interests at stake – the policy interests against the other systemic interests – to decide questions of bias, but the same is not relevant here. *See*, Atrill, *supra* note 86, at 284-89.

98 [2000] HCA 48 at 48 (Kirby, J.).

99 [2008] NICA 11 at 26 (Girvan L.J).

100 *Dinakaran*, *supra* note 1, at 45 (Singhvi, J.). The Court refers to *observer* as "Reasonable, objective, and informed". *See also*, *Davinder Pal Singh*, *supra* note 82. The Court briefly mentions *Dinakaran* and the *observer* standard, but does not discuss how it applies the same in arriving at its conclusions.

famous decision in *Manak Lal*, a common underlying theme emerges providing clarity on how the issue of bias is adjudicated in India. Unlike their common law counterparts, Indian Courts have always been firm on the *viewpoint* from which the facts should be considered that of an outsider. The different phrases such as "real likelihood" and "reasonable suspicion" have been employed only to refer to a varying threshold to evaluate the *degree* of bias required, as against indicating differences on both levels of *degree* and *viewpoint*.

The decision in *Dinkaran* provides support for this argument and as highlighted in the essay, has made this separation clear when Justice Singhvi lays down his formulation of the test. Putting questions on the nature of usage of phrases such as "real likelihood" and "real danger" to bed, Justice Singhvi opens up a potential Pandora's Box by adopting the "fair minded and informed observer" to describe the *viewpoint* from which allegations are to be considered. An *informed* observer has been imputed with a vast degree of knowledge by courts in England, which has rendered the exercise itself nugatory, and it is with the same dangers that this test finds itself used in *Dinakaran*. As a result, the judiciary has possibly endangered the longstanding principle of considering the viewpoint of a reasonable man, making the concurrence with the common law a matter of concern. Past experience favours understanding the "observer" as just another phrase for the reasonable man, but the contrary possibility does exist, and one must hope the mistakes made abroad are not imported along with the *observer* in the years to come.

SECULARISM IN INDIA AND ISRAEL: A STUDY IN JUDICIAL ATTITUDES

*Arushi Garg**

Abstract

This paper seeks to compare the judicial trends with respect to secularism in India and Israel. Despite obvious similarities, it is found that the Indian court is decidedly less progressive than its Israeli counterpart when it comes to going against the dominant religious group. It is suggested that the composition of the judges in Supreme Courts of both the countries is perhaps the explanation. The political structure of Israel has also been proposed as a probable cause, with political parties in Israel wielding more power than is the norm in other jurisdictions. This circumstance has led the political elite in Israel to insulate the Judiciary from politics with great fervor, which has now translated in the Judiciary actively opposing the political group wielding the most power. This is also the most powerful religious group in Israel today. It has further been proposed by the researcher that a realist explanation of the Indian Apex Court being constituted almost exclusively by Hindu judges at any given time must also be kept in mind. The insistence of essentially secular judges to deal with religious matters has resulted in a very broad discretion being conferred upon itself by the Supreme Court in India - a discretion that has not always been exercised in an unbiased manner. It is thus concluded that while the Israeli Judiciary faces its own set of problems, Indian courts would do well to be inspired by them to adopt counter-majoritarian stands. The first step would be to acknowledge a bias, and then work towards erasing it.

INTRODUCTION

The similarities and differences in the legal systems of India and Israel have often caught the attention of scholars. Both nations are fairly young- while the creation of Israel dates back to its Proclamation of Independence (1948),[1] India became independent in 1947, and adopted its Constitution in 1950. The formation of both countries is heavily linked to the majority religion, albeit in very different ways. Those studying India will find it hard to ignore the Partition of 1948 that divided the land controlled by the British Empire into two countries, India and Pakistan. This was a direct result of the threat perceived by Muslim activists at the time of independence who, under the leadership of Muhammad Ali Jinnah, demanded a homeland of their own and refused to be governed by the largely Hindu Congress Party of that time. As far as Israel is concerned, the Proclamation itself describes the State of Israel as a "Jewish State."[2] What is interesting is

* V year, B.A., LL.B. (Hons.), NALSAR University of Law, Hyderabad. The author would like to thank Professor Garoupa of the University of Illinois (Urbana Champaign) for providing her with his invaluable encouragement and advice during the writing of this article.

1 Proclamation of Independence (1948) [hereinafter Proclamation].

2 *Id.*

that both States have nonetheless avowed themselves to the establishment of secularism in their respective jurisdictions.

The aim of this paper is to explore the different manners in which the Supreme Courts of India and Israel have dealt with religious conflicts despite being similarly situated in many respects. One finds that while the Indian Supreme Court has been ambivalent at best, and anti-secular at worst, the Supreme Court of Israel has proved itself to be resilient against the ultra-orthodox religious right. The first part of this paper analyses the premises on which secularism has been based in both countries. The second part explores the similarities in the legal and religious landscape and the third and fourth parts deal with litigation surrounding religious issues in Israel and India respectively. The fifth part compares the two attitudes and analyses the reasons for the same and the sixth and final part is the conclusion.

It would be prudent to indicate here, that, while extensive reliance has been placed on Supreme Court decisions from both countries, the researcher was constrained by a lack of knowledge of Hebrew and hence could not refer to the original text of Israeli judgments.[3] In the case of India, while most of the verdicts referred to are from the Supreme Court, the occasional High Court judgment has been referred to for two reasons. One, it is the joint responsibility of both the High Court and Supreme Court to secure fundamental rights (including the right to freedom of religion) for the people.[4] Two, the strong doctrine of *stare decisis* in India, along with a unitary judiciary, ensures at least a basic level of consistency between the judgments pronounced by the Supreme Court and High Courts.

I. Theories of Secularism

The concept of secularism is multifaceted as well as flexible. The classical "Western" theories have emphasised on the "Wall of Separation" model of secularism. This model was best summarised by Donald Eugene Smith as encompassing three relationships- between the individual and religion (freedom of religion), the state and the individual (citizenship) and the state and religion (separation of church and state).[5] This is still the case in countries such as France where the policy has always been to say "no" to expression of religious affiliations in public. But this model has come under severe strain following increased migration from former European colonies and intensified globalisation.[6] In particular, it has been challenged in both India and Israel, where the understanding of secularism is influenced heavily by local factors.

3 The author has referred to available secondary sources, particularly ones accessible through online database Westlaw.

4 Constitution of India, Articles 32 and 226.

5 Ronojoy Sen, *Legalising Religion:The Indian Supreme Court and Secularism*, *available at* http://www.eastwestcenter .org/sites/default/files/private/PS030.pdf [hereinafter Ronojoy Sen].

6 Rajeev Bhargava, *States, Religious Diversity andthe Crisis of Secularism, available at* http://www.opendemocracy.net/ rajeev-bhargava/states-religious-diversity-and-crisis-of-secularism-0 (last visited Mar. 22, 2011). [hereinafter Bhargava].

When it comes to talking about the adaptability of western secularism to India, it has been said that, "religious and secular life are so pervasively entangled [in India] that a posture of official indifference cannot be justified."[7] Some authors have taken this observation even further and claimed that *any* secular model is bound to fail - and rightfully so-in a society that is, by its nature, as religious as Indian society. This author has however premised her research on the existence of an "Indian" theory of secularism.

The Indian theory of secularism is one of equal respect to all religions. This means that while the Indian State is secular, it is not irreligious, and maintains a principled distance from all religious groups. Looked at another way, the antonym of "secular" in Indian society is not "religious" but is "communal".[8] The three strands of religious freedom, celebratory neutrality and reformatory justice are the core elements of Indian secularism. The idea of social reform is deeply entrenched in Indian society, and the separation between state and religion is not enough to secure this end. Removal of inequalities between religious groups implies that the state has broad powers to assist, financially or otherwise, in the celebration of all religious groups, to allow them to stand by not just religious beliefs, but also practices and rituals. It implies reform wherever it is necessary.[9]

However, it has also been suggested that the Indian understanding of secularism is greatly influenced by ideas of Hindu nationalism, which in turn means that the emphasis is on secularism as a means to obtain national unity. This was best reflected in the recognition of secularism as an aspect of the basic structure of the Indian Constitution in a landmark case to justify the imposition of an Emergency in various states so that the unity of the nation as a whole did not suffer.[10] The problem arises when the line between national unity and homogenisation of the nation is crossed, leading to an imposition of majority perspectives. This may be one reason why the rights of minorities have taken a backseat in the modern day discourse surrounding secularism.[11]

Israel presents a different story. Herzl, the father of political Zionism, was determined that the Zionist project would "keep our priests within the confines of their temples."[12] Modern day Israel is not reflective of these aspirations. The Jewishness of Israel today is undisputed, though complex.[13] The specific attitude to Judaism itself varies, but the central focus on Judaism is something that seems to pervade all discussions

---

7 Ronojoy Sen, *supra* note 5.

8 Thomas Pantham, *Indian Secularism and Its Critics: Some Reflections*,The Review ofPolitics, Vol. 59, No. 3, Non-Western Political Thought, pp. 523-54, at p. 525 (1997).

9 Bhargava, *supra* note 6.

10 Annette Grossbongardt, *Unholy Conflict in the Holy Land*, Jul. 3, 2007, *available at* http://www.spiegel.deinternational/0,1518,469996,00.html [hereinafter Grossbongardt].

11 Ronojoy Sen, *supra* note 5.

12 Grossbongardt, *supra* note 10.

13 Jonathan Marcus, *Secularism v. Orthodox Judaism*, Apr. 22, 1998, *available at* http://news.bbc.co.uk/2/hi/events/israel_at_50/israel_today/81033.stm.

on secularism.[14] Even "progressive" measures and judgments often make concessions only to make the Zionist project more acceptable to various religious groups, while never advocating the outright divorce of religion from politics.[15]

Thus the understanding of secularism varies as per the society in which the theory is discussed. As can be gathered from the above discussion, it is mostly ameliorative in Indian society, but visionary in Israel.[16] This would mean that while secularism always connotes a reference to the relationship between state and religion, the motivations that have led to the evolution of this relationship vary from one society to another. In India, secularism is grounded in attempts to mitigate the social inequalities that result from religion. In Israel, secularism is meant to ensure that even though Israel remains a Jewish state, commitments to preserve religious liberties and cultural autonomy are not compromised. The central role of Judaism is openly acknowledged, and secularism serves to ensure that alternative systems of faith get minimum guarantees.

While both India and Israel are intensely religious societies, it is to be noted that the State of Israel makes the assumption of religiosity for all its people. For example, secular marriages are impossible in Israel. Religious courts govern several personal law matters in Israel. In India, parties have the option of being governed by secular law, even if the dispute is marital. It is the law and not the forum that varies with religion. In short, both models recognise the inevitable failure of any attempt to "privatise" [17] religion, as well as the social tensions that a Western model is likely to lead to. Both India and Israel realise that exact equality in treatment of religions is not going to further the brand of secularism they seek to promote. While in India this is based on how much intervention is required to make society as a whole just, in Israel there is an intrinsic acceptance of inequality that can be sourced to the object of the formation of Israel itself.[18] Multiple religions in India are not "extras", [19] in Israel, they are.

This ties in deeply with the subject of this paper. Both the subject matter and phraseology of judgments dealing with religion in India are concerned with securing rights for the disadvantaged religious class (the questions of whether the courts take forward the theoretical concept of "ameliorative secularism" is one that has been explored in-depth in the remainder of this paper). In Israel, the role and understanding of Judaism is what informs judicial discourse in general. The extent to which other faiths are

14 *Secularism in Society and Culture*, Dec. 14, 2008, *available at* http://www.idi.org.il/sites/english/events Other_Events/Pages/SecularisminSocietyandCulture.aspx.

15 Narendra Subramanian, *The Wheel of Law, India's Secularism in Comparative Constitutional Context, by Gary Jeffrey Jacobbson,* Sept., 2003, *available at* http://www.bsos.umd.edu/gvpt/lpbr/subpages/reviews/Jacobsohn03.htm.

16 *Id.*

17 Rajeev Bhargava, *India's Model: Faith, Secularism and Democracy*, Nov. 3, 2004, *available at* http://www.opendemocracy.net/arts-multiculturalism/article_2204.jsp [hereinafter Bhargava II].

18 Bhargava, *supra* note 6.

19 Bhargava II, *supra* note 17.

considered is confined to minimising collateral damage when it comes to retaining the essentially Jewish nature of the Israeli state.

II. The Indian and Israeli Frameworks

In India, secularism has now been pronounced by the Supreme Court of India[20] to be a part of the basic structure of the Constitution and cannot be done away with even by a constitutional amendment.[21] Articles 25 to 28 guarantee individuals as well as groups the right to freedom of religion. However, Article 25 restricts the exercise of this right in the interests of public order, morality and health and all *other rights* enumerated in Part III of the Constitution. Therefore, it is constitutional for the legislature to place social welfare and reform over and above religious interests. In fact, Article 17 of the Constitution is a rare example of a penal constitutional provision which criminalizes untouchability; a practice that can essentially be traced to Hinduism. Article 25, itself specifies that the freedom of religion cannot be used to restrict access to Hindu places of worship to upper castes. This relatively lower position that has been accorded to the freedom of religion in the Constitution is starkly different from the manner in which this has been played out in courts and political arenas in India. Many recent constitutional controversies in India have focused on religious rights.

The State of Israel is particularly interesting in this regard since its foundational document itself specifies a Jewish basis, a provision that has no parallel in India. But, this does not mean that Israel is a theocracy. No doubt, it is a State established as a homeland for the Jews but it remains to be seen what it means to be a Jew in Israel. The Proclamation refers to the "*spiritual, religious and political identity*" of the Jewish people and their "*natural and historic right*" to the land of Israel (as opposed to their religious right).[22] The Proclamation seems to suggest Judaism as a way of life, and not simply as a religion. This debate is both massive and heated in Israel, and forms the epicenter of most religious controversies. But there is no doubt that at least theoretically, Israel has committed that "it will ensure complete equality of social and political rights to all its inhabitants irrespective of religion, race or sex; it will guarantee freedom of religion, conscience, language, education and culture; it will safeguard the Holy Places of all religions; and it will be faithful to the principles of the Charter of the United Nations."[23] (emphasis supplied) The right to the freedom of religion in even the "Jewish" State of Israel has been recognized by the Supreme Court of Israel[24].[25]It must also be remembered that Israel was established in the wake of World War II, where the notion of a "Jew" had expanded beyond the

20 Hereinafter SCI.
21 S. R. Bommai v.Union of India, AIR 1994 SC 1918 (1994) [hereinafter *Bommai*].
22 Proclamation, *supra* note 1, at ¶11.
23 Proclamation, *supra* note 1, at ¶12.
24 Hereinafter Supreme Court.
25 Israel Theatres v. Municipality of Netanya, 47 (3) PD 192 (1991).

contours of a religious identity and was identified with distinctive cultural and ethnic traits.

The situation in Israel has much to do with the Status Quo Agreement that was signed between Ben Gurion (the first Prime Minister of Israel) and the ultraorthodox Jewish political party of Agudat Yisrael under which the observance of fundamental Jewish religious practices was not to be disturbed even under the secular State of Israel. The Status Quo Agreement refers to a letter that was written by Ben Gurion to the Agudat Yisrael in order to present a joint proposal to the United Nations to deal with the problems that were likely to face the emerging State of Israel. It marks the compromise that was entered into by the ultraorthodox and liberal, secular Jews of the time who needed each other's support to form the coalition government. It is essentially a codification of the customary practices that had been followed all the way through the Ottoman Empire as well as the British Mandate.[26]

The dominant religion in India is Hinduism with 80.5% of the population identifying themselves as Hindu.[27] In Israel, 75.5% of the population is Jewish.[28] Of these, 42% are secular, 8% are ultraorthodox or *haredi* while the remaining are religious, traditional or religious-traditional.[29]

An important fact to note here is that religious conflicts in India have been found to be inter-religious rather than intra-religious, although the danger posed by the latter must not be undermined. This is in contrast with Israel where the tension is most intense between ultraorthodox and secular Jews.[30]For a variety of historical and political reasons, the numerical minority of ultraorthodox Jews in Israel are known to wield a disproportionate amount of power.[31] They operate through many political parties that have, especially in recent years, been politically influential. As will be further explored, the need for coalition government increases the bargaining power of ultraorthodox political parties manifold.[32] Another key difference is the presence of a singular ecclesiastical organization in Israel, which is lacking in India for the majority religion Hinduism. The Chief Rabbinate in Israel was initially established by the British as an overarching religious

26 Federal Research Division of the Library of Congress, *The "Who is a Jew?" Controversy* (1988), *available at* http:/countrystudies.us/israel/46.htm.

27 Government of India, *Census Data* (2001), *available at* http://www.censusindia.gov.in/Census_Data_2001/India_at_glance/religion.aspx

28 Central Bureau of Statistics, State of Israel, *Press Release* (2008), *available at* http://www.cbs.gov.il/mifkad/mifkad_2008/hod6_2_e.pdf.

29 YNet News Service, *Israel 2010: 42% of Israeli Jews are Secular*, May. 18, 2010, *available at* http://www.ynetnews.com/articles/0,7340,L-3890330,00.html.

30 Marc Gallanter and Jayant Krishnan, *Personal Law and Human Rights in India and Israel*, 34 Isr. L. Rev. 101 (2000).

31 Ran Hirschl, *Constitutional Courts vs. Religious Fundamentalism: Three Middle Eastern Tales*, 82 Tex. L. Rev. 1819, 1820-34 (2004) [hereinafter Hirschl].

32 Margit Cohen , *Women, Religious Law and Religious Court in Israel* (2004), *available at* http:/www.enelsyn.gr/papers/w14/Paper%20by%20Prof%20Margit%20Cohn.pdf.

institution who enjoyed the patronage of the State authorities,[33] in exchange for encouraging loyalty to them. It has no counterpart in India. How these circumstances have helped evolve markedly different theories of secularism in both places has been discussed in the next segment of this paper.

III. The Indian Supreme Court- A Position Of Ambivalence or Bias?

The SCI has been known to be an extremely activist court in most respects. The power of judicial review of legislation is provided for explicitly in the constitution even though it has been observed time and again that this is merely "abundant caution"[34] because judicial review is inherent to the institution of the Judiciary. There is, hence, no doubt at all that all laws in the country must comply with Part III of the Constitution wherein lie enshrined the fundamental rights of the people, including the right to freedom of religion.

The controversy around religion in India has been marked by a general hesitation on the part of the SCI to intervene in matters of religion. One of the earliest cases in this regard is the case of *Narsu Appa Malli*[35] wherein the statutory prohibition on polygamy among the Hindus was questioned as contravening the right to freedom of religion. The Bombay High Court ruled that this was a constitutional measure of reform and upheld the impugned provision as valid.

The Court went on to add that even though this was valid as a reform measure (and hence not violative of the freedom of religion enshrined in Article 25) personal law does not have to comply with Part III of the Constitution at all. Even though "customs" are a part of the laws that are required to comply with the fundamental rights provisions of the Constitution, personal law is distinct from custom and falls beyond the pale of constitutional rights review. As an aside, the Court added that since polygamy had economic, religious and social justifications, it could not be regarded as discrimination "only" on the grounds of sex (as is required by the Indian Constitution) and if reviewed, could not be held to be unconstitutional. This case is important because several judgments from the SCI have used it as a point of reference subsequently.

The *Narsu Appa Malli* case[36] illustrates two important tendencies that have been reflected in judicial discourse in the following years. The reflex of courts in India, when it comes to discussing matters of religion is to staunchly follow a policy of non-intervention. If for some reason they find it in themselves to intervene, it is mostly to uphold the religious practice, even if it is blatantly in contravention of the fundamental rights. This last point is specifically important from the point of view of the cited judgment.

33 Elkan D. Levy, *History of the Chief Rabbinate*, Office of the Chief Rabbi, *available at* http://www.chiefrabbi.org/about-us/history-of-the-chief rabbinate/#.T6oMn-iit98.

34 AK Gopalan v. State of Madras, 1950 SCR 88 (1950).

35 The State Of Bombay v. Narasu Appa Malli, AIR 1952 Bom 84 (1952).

36 *Id.*

The Court describes two seemingly contradictory positions - one, that the law is valid on grounds of Article 25 since reform of religious practices has been brought about by it. Two, if the institution of polygamy were to be reviewed, it could not be regarded as discriminatory under the Constitution, casting doubt on the assertion that doing away with it was reform in the first place. Simply put, if the institution is not discriminatory, why does it need reform?

This inconsistency has little bearing on the judgment because in this case the question of constitutionality of polygamy (as opposed to the constitutionality of the statute prohibiting polygamy) was not raised before the Court and hence must be regarded as *obiter*. However, the almost obsessive deference and reluctance it brings out it are certainly typical of the attitude that is reflected by Indian Courts when it comes to testing the constitutionality of religious practices. It is also notable that both the arguments, as well as the judgment focus on the ameliorative role of the State when it comes to laws relating to religion.

In a plethora of cases that followed, the truism that personal laws are not subject to Part III of the Constitution was posited. No rationale was given. Repeatedly, personal laws were given blanket immunity in spite of the explicit constitutional exceptions to the right to freedom of religion.[37] Initially no distinction was made between statutory and non-statutory personal law.

The situation got complicated with cases such as *Githa Hariharan v. Reserve Bank of India*[38] wherein the constitutionality of Hindu guardianship laws was in question. The case involved a statutory provision wherein the "father and after him, the mother" was declared to be the natural guardian of the Hindu child. Review was carried out, but only lip service was paid to the right to equality. The SCI held that if this provision was read down, it could be given a constitutional interpretation and hence refused to strike it down. The interpretation given by the SCI was that the father was the default guardian but in case of his absence the mother became the guardian. The SCI further claimed that if the phrase "after him" was used to connote death, it would become discriminatory but the understanding given by the SCI was harmonious with the constitutional guarantee of equality. This is absurd considering the father still remains the default guardian and the mother is only given the second preference.

This case can at least be understood as including written personal law within the ambit of law subject to judicial review but in different cases, without even discussing the cases that accord a special status to personal law *vis-à-vis* constitutional review, the SCI has gone on to test the validity of non-statutory religious law also. The position of the SCI

37 Krishna Singh v. Mathura Ahir, AIR 1980 SC 707 (1980); Maharshi Avdhesh v. Union of India, 1994 Supp (1) SCC 713 (1994); Ahmedabad Women Action Group & Ors. v. Union of India, 1997 3 SCC 573 (1997).

38 Githa Hariharan v. Reserve Bank of India, 1999 2 SCC 228 (1999).

has thus been exceedingly ambivalent.[39] The case of *Saumya Ann Thomas v. State of Kerala*[40] is one of the most recent cases to have pointed out this dichotomy. The Kerala High Court held that in the light of SCI observations all statutes must be subject to judicial scrutiny based on Part III while non-statutory personal law, as per precedent, need not. In the same case, even though it was *obiter*, the legality of carving out a personal law exception in a secular State was questioned and it was suggested that this position be reviewed by larger bench strengths than have so far dealt with the issue. The case is pending in appeal before the SCI.

This ambivalence moves towards bias when it comes to cases which have both religious and secular elements, and where the SCI has more flexibility. Take, for instance, the case of *Dr. Ramesh Yeshwant Prabhoo v. Shri Prabhakar Kashinath Kunte & Others*,[41] wherein the election of a candidate was impugned on grounds of having appealed to voters on religious grounds of *Hindutva*. In a stunning observation, the SCI held that *Hindutva* was a way of life, rather than a religion and an appeal based on *Hindutva* did not thus qualify as an appeal based on religion. In doing so the SCI universalized the experience of a majority and swept under its general umbrella, the experience of even minorities living in the same geographical regions.

The SCI also absolved one candidate on account of the fact that even though he spoke of establishing a state along religious lines (the "Hindu" state of Maharashtra) as part of his manifesto, he did not seek votes on this ground. It is strange that even statements made during the course of an electoral speech were somehow construed not to be appeals to vote. It is true that the ancient Greeks regarded "Hindu" as both a secular and religious term, as did counsel for the accused in the *Hindutva* case, but other examples of people who have perceived the term "Hindu" as not having any religious connotations are few and far between.[42]

Ultimately, the election was struck down for all the hateful speeches that were spewed as a part of the campaign but the SCI failed to realize that by giving the narrow definition to the word "religion" that they did, they were going up a slippery slope. Any religion, by its nature is a way of life, and by attributing this fundamental characteristic of religion solely to Hinduism, the SCI created an artificial inequality among equals. At the other end of the spectrum you do have the SCI going out of its way to keep in check fundamentalism among the Hindus. The case of *S.R. Bommai*[43]comes to mind where the

39 Mihir Desai, *Flipflop on Personal Laws* (2005), *available at* http://www.indiatogether.org/combatlaw/vol3/issue4/flipflop.htm.

40 Saumya Ann Thomas v. State of Kerala, (2010) 1 KLT 869 (2010).

41 Dr. Ramesh Yeshwant Prabhoo v. Shri Prabhakar Kashinath Kunte & Others, 1996 SCC (1) 130 (1996).

42 V.M. Tarkunde, *Supreme Court Judgement: A Blow to Secular Democracy, Jan.* 19, 1996, *available at* http:/www.pucl.org/from-archives/Religion-communalism/sc-judgement.htm.

43 *Bommai*, *supra* note 21.

state governments were suspended by the President and a state of "Emergency" was declared in these states. The reason for this was the communalism being fanned by these regimes. The SCI was emphatic that secularism is part of the basic structure of the Constitution, and if a government cannot function in accordance with this principle then it cannot be carried out as per the Constitution. The proclamation of Emergency was upheld.[44]

But mostly, we have the SCI being accused of a Hindu bias.[45] The upholding of bans on cow slaughter[46] has been regarded as evidence of such a bias. This is because the cow is regarded as sacred by the Hindus. Although the complete prohibition of cow slaughter has been justified on secular grounds, the SCI has been known to pronounce that the sacrificing of cows is not an essential part of Islam, a custom that used to be carried out on the festival of *Bakr-Eid* by most Muslims in India. Again, evidently, the SCI has tried to project giving precedence to a secular prohibition that favors an agrarian society rather than a Hindu belief but the subtext suggests otherwise. In fact, this comes across even more clearly in the way judgments upholding these prohibitions are perceived by the right-wing Hindu audience.[47] It must also be kept in mind that even the inclusion of the directive principle of state policy regarding the prohibition of cow slaughter was at least in part religious.[48]

The root of this problem is perhaps the dangerous power the SCI has bestowed upon itself to decide what is, or is not "essential" to a religion.[49] So we have instances where even excommunication has been allowed for a Muslim cult as an essential practice[50]

---

44 This ruling has remained contentious because of its invocation of the basic structure doctrine. This doctrine was incorporated in Indian constitutional law as a *standard of review* for *constitutional amendments*. The SCI, for the first time used it as a *justification* for *executive action*. It seems that the SCI had resolved to make a bold statement about checking the "saffronisation" of Indian politics, *i.e.*, the percolation of Hindu fundamentalists and their vote-bank politics into Indian polity, and would have achieved this end one way or another. The same result could have been achieved by simply referring to the freedom of religion and the failure of the state governments to guarantee it, but the manner in which the SCI went about reasoning in its judgment reflects resolve to elevate the freedom of religion beyond what it was meant to be treated as by the framers, in a bid to keep check on radical Hindu groups.

45 The Guardian, *Indian Court Accused of Hindu Bias*, Sept. 13, 2002, *available at* http://www.guardian.co.uk world/2002/sep/13/1.

46 State of Gujarat v. Mirzapur Moti Kureshi Kassab Jamat & Ors.,(2005) 8 SCC 534(2005).

47 New Kerala News Service, *Cow Slaughter Banned by Kolkata High Court,* Nov. 12, 2010, *available at* http:// www.newkerala.com/news/world/fullnews-82846.html.

48 Take, for example, the speech of Seth Govind Das during the debate surrounding the issue: "The protection of cow is a question of long standing in this country. Great importance has been attached to this question from the time of Lord Krishna. I belong to a family which worships Lord Krishna as Ishtadev. I consider myself a religious-mindedperson, and have no respect for those people of the present day society whose attitude towards religion and religious-minded people is one of contempt.": Constituent Assembly Debates, Volume VII, (Debate dated 24th November, 1948).

49 Also see, Mohd. Hanif Quereshi v. State of Bihar, 1959 SCR 629 (1959).

50 Sardar Syedna Taher Saifuddin Saheb v. State of Bombay, 1962 SCR Supl. (2) 496 (1962).

(never mind that this defeats in most part, the constitutional mandate against other forms of excommunication such as untouchability), but when pitted against the sacred Hindu cow, the religious practices of Indian Muslims are relegated as "non-essential".

Most recently, the SCI was in the line of fire for dismissing petitions challenging the introduction of *Vedic* astrology in state-funded schools since this form of astrology has its roots in the *Vedas*, which are Hindu scriptures.[51] The SCI upheld the constitutionality of this measure holding that just because a discipline traced its roots to a specific religion did not make it a "religious" course *per se*.

While this decision seems to have at least some secular basis, more controversial is the *Aruna Roy* case[52] which came up before the SCI in 2002. This challenged the revision of history textbooks in government high schools as presenting a biased, Hindu view of history.

For instance, *Hindutva* philosophy separates Hindu philosophy (including all religions that originated indigenously) from the "other" religions such as Islam and Christianity that have their roots in foreign countries. The bedrock of *Hindutva* philosophy is the belief that the Aryans, who gave rise to Hinduism, are sons of the soil of the Indian subcontinent and thus have a more legitimate claim to it.[53] If they too are immigrants from parts of Europe (as scholarship has often suggested) then *Hindutva* loses its meaning since then Hinduism is as alien to the land of India as the Abrahamic religions are. In true keeping with this philosophy, the new textbooks focus on the link between the Aryans and the Harappan culture, sweeping aside other theories of the origin of the race, seriously suppressing the spirit of inquiry. A much more serious, allied issue is the constant portrayal of Muslim rulers as vicious, violent and intolerant, which reflects a broader communal agenda.[54]

The SCI upheld these revisions, distinguishing a study of religion from the kind of "religious instruction" that is prohibited by the Constitution. Justice Shah, who delivered the majority opinion for the SCI states, while talking about religion, "Although it is not the only source of essential values, it certainly is a major source of value generation."[55] Rajeev Dhavan rightly asks, "which religion and what values?" Ambedkar, one of the most prominent of the framers of the Constitution of India was adamant that the State cannot

51 P.M. Bhargava & Ors. v. University Grants Commission, AIR 2004 SC 3478 (2004).

52 Aruna Roy & Ors. v. Union of India, (2002) 7 SCC 368 [hereinafter *Aruna Roy*].

53 Best brought out by the stance adopted by the right-wing party, Shiv Sena, in their conversation about the rights of Hindus in Mahrashtra: Adnan Gill, *Who's Who of the Hindutva Army,* Nov. 12, 2008, *available at* http://www.defence.pk/forums/indian-defence/17427-whose-who-hindutva-army.html.

54 Other theories are dismissed as representing a *"biased colonial view"* and a *"myth."* Similarly, in keeping with modern Hindu beliefs, all references to beef eating in the Vedic period have been removed: Atishi Marlena, *The Politics of Hindutva and the NCERT Textbooks* (2004), *available at* http://www.revolutionarydemocracy.org/rdv10n2/ncert.htm.

55 *Id.*

be expected to teach all religions. Indeed, *"the State is not a super theologician for synthesising all faiths"*.[56]

The judgment talks about convergence of religions on one hand, and ignores the polarization between *Hindutva* and other religions as reflected in the textbooks. Historical theories of religions such as Jainism and Buddhism coming up as a retaliation to (and not a continuation of) Hinduism have not even been gone into. Ironically, despite all the rhetoric on convergence of values, the judgment ultimately vindicates the move of the State as an attempt to salvage the soul of the Indian student from the "*negative aspects of Western culture.*"[57]

The field of affirmative action through reservation also presents an interesting case study. The Constitution itself provides for reservation, but entirely in keeping with the orthodox Hindu approach, the SCI has allowed for caste as a relevant factor for the determination of backward classes who can get the benefit of reservation. This has been perceived by many to be anti-secular,[58] more so because Scheduled Castes in India have already been given the status of beneficiaries of affirmative action. But more than the factoring in of castes while deciding on the beneficiaries of reservation, it has been the tenor of the judgments of the SCI that has proven to be most disturbing with the Judiciary insisting, time and again, that the objective is not to ultimately eradicate the caste system but to eliminate discrimination based on the caste system.[59] This aim may seem *prima facie* laudable, but in the context of Indian society it is either hypocritical or naïve. In modern times, there is a concerted effort to ensure that the caste system ceases to have any relation with occupations. At the same time class mobility remains well-nigh impossible. Stripped from its connection with occupations, the only relevance of the caste system remains the hierarchy it imposes. To say that retention of the caste system is permissible is more or less accepting that the hierarchy that goes with it is permissible. Caste blindness may not be the solution, but the tenor of SCI observations seems to lean in favor of preserving an orthodox, Hindu institution that no rule of law society should even think of justifying. Reservations along the lines of caste were never meant to be a permanent measure, and the almost fatalistic attitude of the SCI certainly fails to do justice to the intended impermanence of the measure.

---

56 Rajeev Dhavan, *The Textbook Case*, Oct. 4, 2002, *available at* http://www.hinduonnet.com/thehindu/200210/04/stories/2002100401011000.htm.

57 *Aruna Roy*, *supra* note 52.

58 Hirschl, *supra* note 31.

59 For instance, Ashok Kumar Thakur v. Union of India, (2008) 6 SCC 1 (2008), opinion of Balakrishnan, J. at ¶187 where the learned Judge refused to uphold that reservation based on caste is time-bound. Earlier on in the judgment, he reiterates, "There is no gainsaying the fact that there are numerous castes in this country which are socially and educationally backward. To ignore their existence is to ignore the facts of life." Further the argument that "The Constitution never prohibits the practice of caste and casteism…It was argued what the Constitution aims at is achievement of equality between the castes and not elimination of castes." was neither accepted nor rejected by the Chief Justice.

In conclusion, the attitude of the SCI has been inconsistent when it comes to testing laws based in religion against the other rights provided under Part III of the Constitution, even though the Constitution expressly empowers the Court to do so. On the rare occasion that these laws are reviewed, they are almost inevitably found to be constitutional. In fact, as long as the case involves a religious angle, the SCI's judgments tend towards acceptance of the stance of the dominant religious group in India. A number of pretexts have been deployed by the SCI in rationalizing this tendency. These range from artificially carving out Hinduism as a way of life, rather than a religion, to empowering itself through dangerously flexible devices such as the "essential practices" doctrine to rule whichever way it deems fit. In a series of cases (such as the cow slaughter cases) the Court has tried to camouflage its Hindu tendencies with secular facades, but the subtext is strong, and often overwhelming. As has been discussed earlier, most cases involve pitting religion against the public good- perhaps something, which is to be expected- given the ameliorative conception of secularism in India. But, more often than not, the verdict seems to serve the interests of a particular group, rather than mitigation of social evils.

IV. Secularism And The Israeli Supreme Court

Israel does not have an entrenched Constitution yet, but it does have its "Basic Laws" that were drafted by the *Knesset* (the Parliament of Israel). These are akin to a Constitution and have taken their place in the absence of an actual Constitution. The Proclamation has also acquired legal force in Israel, affording many basic rights to the people.

The State of Israel has civil, military and religious courts. All judges in Israel must vow to uphold the laws of the State except the *dayan* (the rabbinical court judge) implying the supremacy of Jewish law over secular law.[60] At the top of the hierarchy is the Supreme Court with both original and appellate jurisdiction. The Supreme Court of Israel first used the Basic Laws of 1992 (the Basic Law: Human Dignity and Liberty and the Basic Law: Freedom of Occupation) to invalidate a legislation passed by the *Knesset* in 1995.[61] The power of judicial review was limited to laws passed after 1992.

The religious courts are regarded as administrative agencies of the State and their decisions are hence subject to judicial review on the basis of rights enumerated in the "Basic Laws."[62] An illustrative case in this regard is that of *Bavli v. Great Rabbinical Court*[63],

60 Federal Research Division of the Library of Congress, *The Judicial System* (1988), *available at* http:/ countrystudies.us/israel/84.htm.

61 United Mizrahi Bank v. Migdal Coop. Vill., 49(4) P.D. 221 (1995) (Isr.) (1995).

62 Anat Scolnicov, *Religious Law, Religious Courts, and Human Rights within the Israeli Constitutional Structure*, 4 Int'l J. Const. L. 734 (2006).

63 Bavli v. Great Rabbinical Court, [1994] IsrSC 48(2) 221 (1994).

where the Supreme Court held that equal division of marital property must be carried out by rabbinical courts, even though this requirement is not in compliance with *Halakka* (Jewish Law). In this revolutionary pronouncement, the Supreme Court went on to hold that rabbinical courts must conform to constitutional norms.

As discussed above, the focus of a lot of Israeli scholarship has been on intra-religious violence. In recent years, a slight shift has been seen in this trend with an increasing Arab consciousness being created in Israel. For instance, the controversy surrounding the national anthem of Israel, the *Hatikva*, was triggered mainly because of the its Jewishness. The Arabs in Israel don't regard the *Hatikva* as respresentative of the non-Jews.[64] In fact, as a sign of protest one Supreme Court Justice Salim Jubran refused to sing the national anthem at the swearing in ceremony of the new President of the Israeli Supreme Court.[65] But most of the cases that reach the Courts are between the orthodox and secular Jews, as will be demonstrated.

The main reason is that even secular Jews, much to their resentment, are subject to the rabbinical courts (*bet din*) in Israel where only ultraorthodox *rabbis* sit. These courts regulate all cases of marriage and divorce between Jews since there is no 'secular' or 'civil' form of marriage. In doing so, they enforce orthodox Jewish tenets of the *Halakka* a lot more strictly than would others. For instance, a child born from adultery is not counted as a Jew and cannot get married. Anyone whose marriage ends with the disapproval of the rabbinical court cannot get remarried. Some of these people take recourse to getting married abroad and then having their marriage recognized in Israel as per the norms of private international law, but this obviously entails much inconvenience and unnecessary expenditure. Divorces can also get complicated because under the *Halakka* the man must complete the divorce by delivering the wife to the *bet din*. Under civil law, the husband could get jailed for unnecessary stalling a divorce but he may choose to withhold consent despite this.

This is just one illustration of the many complications that can arise between the two parallel judicial regimes. The Supreme Court may choose to be secular in matters of Jewish law but many of these reforms are obstructed because the *bet din* can retaliate by withholding permission to marry and divorce as a symbol of disagreement with the perceived secularization of Jewish law. One of the raging controversies in Israel concerns the Law of Return, 1950, which gives those born as Jews, converts and those of Jewish ancestry the right to migrate and settle in Israel as Israeli citizens. The Supreme Court has ruled that it is they and not the rabbinical courts that have the jurisdiction to decide "Who

64 Seth J. Frantzman, *Terra Incognita: Falling out of Love with 'Hatikva'*, May 1, 2012, *available at* \http://www.jpost.com/Opinion/Columnists/Article.aspx?id=268311.

65 Gabe Kahn, *Judge Rubinstein: Arabs Need Not Sing Hatikva*, Mar. 1, 2012, *available at* \http://www.israelnationalnews.com/News/News.aspx/153328#.T6oLbuiit98.

is a Jew?"[66] An anomalous situation arises where the Supreme Court gives liberal interpretations to who a Jew is,[67] and grants the concerned people citizenship but the rabbinical court staunchly disentitles them from getting married or divorced within Israel.

Despite stiff opposition by Israel's most powerful religious group, the Supreme Court has an impressive record in doing away with the stringency of ultraorthodox religious traditions where they conflict with universally accepted conceptions of human rights and liberalism. One of the earliest cases in this regard is one involving a prohibition on the import of non-kosher food, one of the four main areas covered by the Status Quo Agreement.[68] A company called Meatreal approached the Supreme Court challenging this prohibition as violative of the Freedom of Occupation enshrined in the Basic Laws. Despite stiff opposition from the ultraorthodox segment of the Jews, this challenge was allowed, and the prohibition stuck down.[69]

Katz v. Jerusalem Regional Rabbinical Court[70] is also an important case in which the Supreme Court held that the rabbinical courts cannot exercise any authority that is not explicitly vested in them. They are hence not entitled to declare as ostracised anyone who chooses not to have a civil matter adjudicated by a religious court. Similarly, in *Amir v. Great Rabbinical Court* [71] took this *ratio* further and posited that parties could not simply enter into an agreement to have their dispute subject to arbitration by a religious court if the law does not permit it.

The situation is complicated by the presence of a Chief Rabbinate Council, which is the supreme spiritual, and *Halakkic* authority for all Jews in Israel and decides, *inter alia*, the eligibility of people to serve as judges of the religious courts or as *rabbis*.[72] They also have the ability to certify food as kosher. Now according to Jewish beliefs, every seventh year is the *shmita* or the sabbatical year. This is a year of rest in which all land is to be left fallow and whatever grows naturally is the common property of all. Food as a product of deliberate cultivation is hence non-kosher. In order to work around this, for the past one hundred and twenty years or so, an innovative tool called *hetermechira*, or sales permit is being used. Under this, the land is nominally sold to a non-Jew so that the produce from it does not remain non-kosher. After the year is over, the land reverts to the Jew owner.

---

66 Brother Daniel Rufeisen v. Minister of the Interior, (1962) 16 P.D. 2428 (1962).

67 Ron Hirschl, *Symposium: A New Constitutional Order? Panel IV: Towards Juristocracy: The Origins And Consequences Of the New Constitutionalism: The New Constitutionalism And the Judicialization Of Pure Politics Worldwide*, 75 Fordham L. Rev. 721 (2006).

68 The Status Quo Agreement, as has been more fully described in the Introduction, refers to four main areas- *Shabbat* (day of rest in Orthodix Judaism), *Kashrut* (Jewish dietary laws), family laws and education.

69 Meatrael Ltd. v. Prime Minister & Minister of Religious Affairs [1993] IsrSC 47(5) 485 (1993) [hereinafter *Meatrael*].

70 Katz v. Jerusalem Reg'l Rabbinical Court [2000] IsrSC 50(4) 590 (2000).

71 Amir v. Great Rabbinical Court, HCJ 8636/03 (2003).

72 *Chief Rabbinate of Israel Law* (1980), available at http://www.israellawresourcecenter.org/israellaws/fulltext chiefrabbinateisrael.htm.

In 2007, under pressure from the ultraorthodox factions, the Chief Rabbinate left the decision of whether to certify the produce from a *shabbath* year as kosher or not in the hands of the local rabbis. Some of them issued certification of the produce as kosher but others did not. The Chief Rabbinate was dragged to the Supreme Court in *Produce Production and Marketing Board v. Chief Rabbinate of Israel*,[73] wherein it was ordered to return to the previous, centralized policy of kosher certifications. The Supreme Court was careful enough to specify that they did not claim to be interpreting religious law, but the Rabbinate, being an administrative body was bound by principles of administrative law, including norms of fairness, reasonableness and non-arbitrariness. The new policy of the Chief Rabbinate had not relied on adequate data analysis and deliberation. Due notice had not been given of this change in policy. The policy was unreasonable in its failure to balance the interests of the farmer against those of the general public. On all these grounds, the new policy was struck down.

It is also heartening to see the dominant role that has been played by the Supreme Court in eliminating gender inequalities. Even before the 1992 Basic Laws, the 1987 *Poraz* case[74] involved a challenge to the Municipality of Tel Aviv, which refused to appoint women to the committee that selected the city's chief rabbis. This was obviously an attempt to appease the ultraorthodox representatives who constituted roughly two-thirds of the appointment committee. The Supreme Court struck this down as it contravened the foundational tenet of gender equality. This line of reasoning has been adhered to consistently.[75]

Though the Israeli Supreme Court is largely intrepid in the manner in which it stands up to the ultraorthodox elements of Jewish societies, the political power wielded by the *haredis* is such that these verdicts are not always as efficacious as one would want them to be. For example, the *Knesset* responded to the *Meatrael* case[76] by immediately amending the Freedom of Occupation clause on which the judgment was based, and the next time round, in a post-amendment challenge, the Supreme Court had no option but to uphold the validity of the prohibition.[77]

The ruling regarding equal division of marital property was also opposed vehemently by rabbinical courts that, in many instances, refused to follow it. This controversy was given a new dimension in the *Yemeni* case[78] where an innovative loophole was sought to be introduced by the religious courts. The civil statute regarding equal division of marital property was to apply *unless* the parties consented to apply religious

73 Produce Production and Marketing Board v. Chief Rabbinate of Israel, HC 7120/07 (2007).
74 Poraz v. Municipality of Tel Aviv, 42(2) P.D. 309 (1988) (Isr.) (1988).
75 Shakdiel v. Minister of Religious Affairs, 42(2) P.D. 221 (1988) (Isr.) (1988).
76 *Meatrael*, *supra* note 69.
77 Hirschl, *supra* note 31.
78 Yemini v. Great Rabbinical Court, HCJ 9734/03 (2003).

law. The rationale put forward by the rabbinical courts was that once both the parties consented to the jurisdiction of the religious court it was implied that they had both consented to the adjudication of the case based on religious principles. Once again, the Supreme Court had to intervene and overrule the religious court, holding that the consent for the application of religious tenets was to be explicit and clear and could not be inferred merely from contesting the suit before a rabbinical court.

V. A Comparison of Judicial Attitudes

The above survey of both legal systems reveals that in spite of all the similarities between the two nation States, judicial attitudes in the two countries are vastly different. The attempts by the religiously dominant groups in both countries to assert their hegemonic view over everyone else is met with vastly different reactions. In India, SCI rulings regarding the constitutionality of religious practices or laws have been confused, and are incredibly inconsistent for a country that is so committed to the doctrine of *stare decisis*. Cases with religious undertones present an even bleaker picture with the Hindu perspective seeming to guide most decisions of the SCI. *Au contraire*, the Supreme Court in Israel has adopted a critical, liberal attitude, governed not by the experience of the dominant religious group (the *Haredi* Jews) but by ideas that resist the hegemony of the ultra-orthodox.

Hirschl attributes this tendency to advance a secularist agenda to the composition of the Supreme Court in Israel.[79] Judges are selected by a nine-member appointments committee that consists of the President of the Supreme Court, two other Supreme Court Justices, two practicing lawyers who are members of the Israel Bar Association, two members of the *Knesset* elected in a secret ballot by majority vote, and two ministers, one of whom is the Minister of Justice (who also chairs the committee and must approve the appointments). In practice, however, since the establishment of the State, almost all of the appointments committee's members have been representatives of the secular elite. Furthermore, all nine political figures (representing four different political parties) who served as justice ministers until at least 2009 were among the main instigators and supporters of the 1992 constitutional revolution in Israel. It will be interesting to see how far the record of the Supreme Court will be affected in future by a committee that may not be so secular in its approach. Already, the incumbent Minister of Justice has been in the eye of the storm for claiming that Jewish law should eventually become binding in Israel, and that "the Torah has the complete solution to all of the questions we are dealing with." This stance was greatly watered down once opponents accused him of the "Talibanisation of Israel."[80]

---

79 Hirschl, *supra* note 31.

80 Haaretz Service and Yair Ettinger,*Justice Minister: Rabbinical Courts Should Support, Not Replace Civil Courts*, Dec. 8, 2009, *available at* http://www.haaretz.com/news/justice-minister-rabbinical-courts-should-support-not-replace-civil-courts-1.2611.

A lot of the key judicial figures in Israel have been openly leftist. Indeed, the likes of Aharon Barak have stuck out their neck and put a lot at stake just to prevent an anti-secular agenda from being advanced.[81] India presents a different story. In India, the appointment of judges is done by the President, generally in consultation with the collegium of the five senior most sitting judges of the SCI. The appearance and reality of deciding the case strictly on merits, and not on political ideology hence becomes very important. So important, in fact, that a lot of the times the SCI might prefer to refrain from adjudicating upon an issue at all, rather than having to take an uncomfortable side. This is perhaps what has happened in cases where the constitutionality of personal laws is at stake.

The political structure of Israel is also a likely cause. Until 1977, the politics in Israel was dominated by the Mapai and the Labor Party, both of whom had a socialist agenda to pursue. Thereafter, the right wing Likud Party has been the key political player. Attention has been drawn before the heightened role played by political parties in Israel. At the time of the inception of Israel, it was mostly political parties that exercised functions of the State, providing important facilities such as health and education to the immigrants that aligned themselves with these parties. As State machinery took over, the role of political parties has diminished but a variety of ancillary services is still provided by political parties to their members. The key political institutions in Israel even today are not formal government structures but political parties. Political parties in Israel today still "*occupy a more prominent place and exercise a more pervasive influence than in any other state, with the exception of some one-party States.*"[82] Given this massive power exerted by political parties, Israelis feel that the courts are the sentinels that protect them from some of the "*more egregious consequences of their highly partisan politics*."[83] The political elite in Israel consciously decided to insulate the Judiciary from an otherwise acutely politicized society as a means of ensuring the rule of law in Israel, a system that is reinforced and protected till today.[84] In recent years, the politics in Israel has become increasingly influenced by right-wing, conservative parties. This rise has been for many reasons, ranging from the growing proportion of Haredis demographically[85] to the growing racism that has come to mar Israeli society.[86] It is natural that the Courts have remained fiercely secular as a reaction. To increase the role of the government, reforms were proposed in 2008, which were

81 Hillel Neuer, *Aharon Barak's Agenda* (1998), *available at* http://www.jewishagency.org/JewishAgency/English/Jewish+Education/Educational+Resources/More+Educational+Resources/Azure/3/3-neuer.html.htm.

82 Martin Edelman, Courts, Politics and Culture in Israel 9 (1st. ed. 1994).

83 Martin Edelman, *The Judicialization of Politics in Israel*, Int' Pol. Sci. Rev., Vol. 15, No. 2, 177-186 (1994) [hereinafter Edelman].

84 *Id.*

85 AP News Agency, *Jerusalem-AP Report: In Rise of Ultra Orthodox, Challenges for Israel*, Jan. 14, 2011, *available at* http://www.vosizneias.com/73474/2011/01/14/jerusalem-in-rise-of-ultra-orthodox-challenges-for-israel/.

86 Phyllis Bennis, *Israel: Rise of the Right* (Feb. 12, 2009), *available at* http://warisacrime.org/node/39750.

heavily opposed by the activist Judiciary.[87]A four year long study by the Regavin Association concluded that the Supreme Court is clearly biased toward left-wing groups and particularly pointed out Chief Justice Dorit Beinisch's role in this regard.[88] The study focused on the bias in procedure, but it is not hard to infer from that, a bias in ideology also.

This is coupled with the decline of faith in the *Knesset* as well as the political parties and a corresponding increase in public support for the institution that keeps their self-serving agendas in check. Especially since the State lacks a Constitution, the Courts' perceived responsibility to safeguard certain fundamental values is heightened. Moreover, all governments in Israel's short political history have been coalition governments, with the several members of the coalition being unable to reach consensus on the nation building policies to be adopted. The Supreme Court has been willing to deliver, where the politicians have dithered and reached stalemates based on their manifestos or party ideologies. This has resulted in a transfer of powers to the Court, and given them more independence and stability to defy the religiously (and politically) dominant groups.[89]

In Israel, as Aharon Barak has pointed out, the Supreme Court also seems to have a more *legitimate* claim to take strong positions on what the Basic Laws stand for, because these laws are not the same as an entrenched Constitution, and even if the Supreme Court were to take an anti-democratic stand, the laws could be much more easily amended than if the State had had an entrenched Constitution (as India clearly does).[90]

In India, the Judiciary's self-imposed restraint might also be sourced to its constant battles with the Executive and those who have dared to dissent have had heavy costs to pay. The dark period of the Emergency has surely done a lot to shake the faith of a Judiciary that dares to express dissent with the Executive. Even as recently as late 2010, an SCI order saying that food in government storehouses should be distributed before it is allowed to rot was met with Prime Minister Manmohan Singh's scathing remarks on how the Judiciary should not meddle with policy making.[91] It is no wonder that the Judiciary chooses time and again to believe that it does not have the power to review personal laws. The weight of precedent and innovative interpretations of the definition of "law" provide the perfect platform to execute this plan.

---

87 Ezra HaLevi and Gil Ronen, *Justice Minister Proposes Reform Of the Supreme Court* , Jan. 3, 2008, *available at* http://www.israelnationalnews.com/News/News.aspx/124791.

88 Hillel Fendel, *Study Shows That Beinisch Prefers Left-Wing Groups,* July 11, 2010, *available at* http://www.israelnationalnews.com/News/News.aspx/138523#replies.

89 Edelman, *supra* note 83.

90 Edelman, *supra* note 83.

91 Nirmal Sandhu, *The Grain Drain* (2010), *available at* http://www.tribuneindia.com/2010/20100913/nation.htm#11.

Why the apex court should choose to side with a single religious group is a more troubling question. In part this may be because of the personal bias and orthodoxy of some judges that gets reflected in judgments - Justice Markanday Katju, has been known to refer to the growing of beards by young Muslim men as "Talibanisation"[92] and Justice Krishna Iyer, has been known to suggest that judges must remain insulated "like a Hindu widow."[93] But, there seems to be a systemic bias that cannot be explained by individual instances.

Perhaps the realist explanation is the best one. Majority of the population is Hindu, as has consistently been majority of the bench. It is natural for these judges to view everything through a Hindu lens, not because they are corrupt or anti-secular, but simply because they are Hindu. A Hindu mindset might find it hard to understand the insistence of a Muslim student to grow a beard and might find it much easier to dismiss his claim as "Talibanisation" than someone who actually *does* grow a beard as part of his own religion, or knows what it's like to not have people understand the relevance of their religious traditions because they are unfamiliar to the majority. Without the kind of careful composition that one finds in the Supreme Court in Israel, it is almost expected that the pervasive Hindu ideology is embraced more easily by the SCI unless expressly forbidden by the Constitutional text, and sometimes even then.

This is dangerous ground for a State that insists vehemently that it is secular. India has gone to great lengths to ensure a non-partisan, impartial Judiciary. The jury system has been abolished on the assumption that a trained judicial mind will be more impartial than the layperson. But, a bias seems to be reflected consistently. Whether this is conscious or subconscious remains anybody's guess although the likelihood is that it is a little bit of both.

The differing historical roots of both nations are another key difference. In India, initially, the British relied on the advice of "native law officers" such as *pundits* (in case of Hindus) and *kazis* (in case of Muslims) while dealing with personal law matters.[94] Eventually, suspicious of the natives, in an effort to rationalize the law, the post of native law officers was abolished altogether and the British judges themselves referred to religious texts and scriptures in order to adjudicate upon matters of personal law. Obviously, their understanding of these personal laws was not only imperfect, but also tempered heavily with their common law leanings. In much the same way, Indian courts have taken upon themselves the onus of referring to ancient texts to decide for themselves what does and

92 Express India News Service, *SC Judge Apologises For 'Taliban' Remark On Muslims*, July 6, 2009, *available at* http://www.expressindia.com/latest-news/SC-judge-apologises-for-Taliban-remarks-on-Muslims/485727/2/.

93 Judicial Selection Coalition, *Bar To Judgeship*, Feb. 19, 2011, *available at* http://www.judicialselectioncoalition.org/bar-to-judgeship.htm.

94 See for instance, *History of the Uttar Kannada Court*, *available at* http://kar.distcourts.kar.nic.in/aboutCourt kar.

does not qualify as the "essential" part of a religion. This unfettered power is a dangerous thing, since it is the sole discretion of the judge that can declare an age old practice (for instance, the slaughtering of cows by Muslims on *Bakr-Eid*) to be non-essential overnight.

Israel's legal system, on the other hand, is greatly influenced by the Ottoman Empire where the millet system was followed, with different courts for each community, presided by judges from that community. This system was continued throughout the British mandate as well, and persists in large part through Status Quo Agreement in today's system of religious courts.[95] This explains the existence until today of rabbinical courts where the applicable law is strictly Jewish law. However, the jurisdiction of these rabbinical courts has shrunk to cover only marriage and divorce. Thus personal law in India is the forte of common law judges, while in Israel, it is the religious specialists who are the key players.

Most importantly, this is expositive of the approach adopted by the Supreme Courts in both countries. The Supreme Court in India reverts to religion to justify its stance, even when it is ruling against the assertion of some community. To take the aforementioned example forward, the SCI referred extensively to the Holy *Koran* and other Muslim texts before concluding that cow slaughter was not the only way of celebrating *Bakr-Eid* even if it was an option in Islam. This made it non-essential. In Israel, on the contrary, because religion has traditionally been confined to religious courts, when a case comes up before the Supreme Court, there is a high likelihood that it will be decided on secular grounds. Take for instance the case involving the production of kosher food in the *shabbath* year. The Supreme Court decided to rely on norms of administrative law rather than religious law. In order not to completely antagonize the ultraorthodox wing, they did refer to rabbis who had spoken in favor of what the Supreme Court was laying down, but ultimately the basis of the decision was based in administrative, secular law.

This somewhat hesitant, but decidedly secular approach of the Supreme Court is further reflected in the *Women of the Wall* case,[96] where the right of women to worship at the Western Wall was in conflict with the ultraorthodox beliefs restricting it in some areas. Initially, when the matter was referred to the Supreme Court they urged the government to find a tenable solution that balanced interests of both parties but also stated that in case there was a direct conflict, religious mandates would prevail since the matter was an excessively volatile one. The government failed to work effectively towards a solution that was agreeable to both parties and eventually, when the case came up before the Supreme Court a second time, it ruled in favor of the female worshippers.[97]

95 Josh Goodman, *Divine Judgment: Judicial Review of Religious Legal Systems in India and Israel*, 32 Hastings Int'l & Comp. L. Rev. 477 (2009).

96 Hoffman v. Custodian of the Western Wall, 48(2) P.D. 265 (Isr.).

97 Hoffman v. Gov't of Israel, 54(2) P.D. 345 (Isr.).

The trend in Israel is to secularise, the trend in India is to de-secularise. A case in point is the *Babri Masjid* case[98], which was essentially a property dispute between Hindu and Muslim religious bodies, the former claiming that the property in question is the birthplace of Lord Rama, the latter claiming that it is a mosque. The infant Lord Rama was joined as a party in this "property" dispute, and one third of the property was actually awarded to this Hindu deity![99] Most agreed that this was a workable compromise[100], but lacking any sound legal basis. While some commentators feel that there is no real need to unpack "legal niceties",[101] some eyebrows have certainly been raised at the deliberate introduction and consideration of the religious element in a dispute that should not have been viewed with a religious lens at all.[102]

These differences are also reflected very clearly in the reaction that the introduction of uniform law evokes in both countries. In India, this opposition is headed by the minorities who feel that the enforcement of any uniform code will be driven only by the experience of the majority religion, and the SCI's rulings in the past have not done much to invoke any faith in a truly secular judicial attitude. For the same reason, intense "Hindu" groups have been known to support the cause of a uniform civil code.[103] In Israel, the opposition derives most of its strength from ultraorthodox Jews or *Haredis* who exert a considerable power over the regulation of Jews in Israel through their veto powers in cases of marriage and divorce. If the system of religious courts is abolished, the enforcement of the resulting code is likely to be in a considerably more liberal, secular manner in keeping with the record of the Supreme Court so far.

There are differences resulting from and driving judicial attitudes in both countries, but Indian courts should perhaps review their own performance in the light of Israeli experience to test the depth of their brand of secularism. Indeed, what the countries can learn from each other may as well be the subject matter of a separate study, but the differences in the judicial notion of secularism in both countries are best understood by looking to both the similarities and the differences in the religious, social and legal landscapes of the countries.

98 Refer to the *Ram Janm Bhoomi-Babri Masjid* Ayodhya Bench ruling (2010), *available at* http://www.allahabadhighcourt.in/ayodhyabench4.html.

99 NDTV, *Ayodhya Verdict: Allahabad High Court Says Divide Land In Three Ways*, Oct. 1, 2010, *available at* http://www.ndtv.com/article/india/ayodhya-verdict-allahabad-high-court-says-divide-land-in-3-ways-56063; Nivedita Menon, *The Second Demolition: Ayodhya Judgement, September 30, 2010,* Oct. 2, 2010*, available at* http://kafila.org/2010/10/02/the-second-demolition-ayodhya-judgement-september-30-2010/.

100 The Hindu, *Intriguing Compromise Could Work,* Oct. 1, 2010, http://www.thehindu.com/opinion/editorial/article804948.ece.

101 Pratap Bhanu Mehta, *The Leap and the Faith* (Oct. 1, 2010), *available at* http://www.indianexpress.com/news/the-leap-and-the-faith/690939/0.

102 Rajeev Dhavan, *A Clumsy Verdict of Doubtful Legality*, Oct. 4, 2010, *available at* http://epaper.mailtoday.in/4102010/epaperpdf/4102010-md-hr-12.pdf.

103 Mukul Kasavan, *The Ram Mandir Campaign Threatens the Republican Principle*, Sept. 23, 2010, *available at* http://www.telegraphindia.com/1100923/jsp/opinion/story_12967458.jsp

VI. Conclusion

This paper has sought to establish that despite being similarly saddled with religious tensions in secular societies, the Supreme Courts in both India and Israel have chosen to adopt different trajectories, with the Israeli Supreme Court being much more progressive in its outlook than its Indian counterpart is. The Indian Supreme Court either has exhibited great ambivalence when it comes to deciding the constitutionality of religious practices. When one expands this area of study to include cases where religion has a dominant role to play, the trend is to support the Hindu perspective over the secular one.

One of the major reasons for this difference is the composition of the Israeli Supreme Court, and the backing of more secular judges by the selection committee. India has never had such a support system. The key functions exercised by political parties and their role as the key political institutions in Israel (overshadowing even the State machinery) make it more natural for the Supreme Court to take a viewpoint that sharply opposes that of the dominant political parties- mostly right wing now- since it becomes all the more important to protect the supporters of an opposition from having to deal with the imposition of a religious or political organization they don't want to affiliate themselves with. With India on the other hand, the hesitation of the Supreme Court can be attributed to a cultural conditioning of deference to the legislature, and its tendency to *Hinduise* due to its composition of mainly Hindu judges. While Israel has had its costs to pay in the form of boycott of judgments and low enforcement levels, India has had to pay in terms of a compromise on its secular tradition, which might prove to be a much heavier cost in the long run.

The Rigid Employment Protection Legislations In India And Its Impact On The Economy- Is Flexicurity A Viable Solution?

Pallavi Arora[*]

Abstract

The Indian labour market has been rendered inflexible by a voluminous body of Employment Protection Measures. In the guise of protecting the interests of the workers, the highly rigid labour laws actually work to the detriment of the employers and the overall economy. This paper, whose central premise, proposes the implementation of the policy of flexicurity, does so as a solution to the existent inflexible condition of the Indian labour market. To further this premise, the article comprehensively analyzes the adverse impact of the highly regulated labour market on the Indian business environment. Thereafter, the author examines the working of the flexicurity model and its successful implementation in Denmark. Finally, the article discusses whether or not the flexicurity model can be replicated in India's socio-political milieu.

Introduction

Post-independence, Pandit Nehru sought to make India the poster child for socialism among third world countries and hence actively pursued economic independence by scripting India's retreat from international trade.[1] But this golden hearted socialism soon succumbed to the license raj, red-tapism and nepotism. India receded into a cocoon of superficial self-sufficiency and became a land of a million controls.[2] Thereafter, the inevitable economic reforms of 1991 acted as a panacea to India's caged economy. Gradually, the State's over-regulative character diminished and India steadily marched along the lines of a market economy.[3]

The rigid labour laws of India, which allow for significant intervention and regulation by the State, were also modeled along the principles of socialism.[4] But even though India promptly adopted the Liberalization-Privatization-Globalization policy in 1991, no efforts were made to alleviate the Indian labour market of its highly rigid Employment Protection Legislations.[5]

---

[*] V Year, B.A. LL.B. (Hons.), Dr.Ram Manohar Lohiya National Law University, Lucknow.

1 *See* J. Ahrens, *Prospects of Institutional and Policy Reforms in India: Toward the Model of a Developmental State,* Asian Development Review (1997).

2 *Id*

3 *See* K. Inoue, *Industrial Development Policy of India*, Occasional Paper Series No. 27: Institute of Developing Economies (1992).

4 *See* A.N. Sharma, *Flexibility, Employment and Labour Market Reforms in India*, Economic and Political Weekly (2006).

5 *See* T. Das, *The Impact of Research on Policymaking: The Case of Labour Market and External Sector Reforms in India,* Economic Research Network (2006).

This article attempts to establish the adverse impact of the stringent labour laws on India's business environment and proposes the implementation of the flexicurity model as a viable alternative. Part I of the article examines the inflexible nature of the Employment Protection Legislations in India. Part II discusses the adverse impact of the rigid labour laws on the Indian business environment. Part III illustrates the ills associated with a policy rendered ineffective by labour market flexibility. As a solution, it analyses the concept of flexicurity by comprehensively evaluating its merits and demerits. Further, this Part shall also examine the practicality and the means of replicating the flexicurity model in India. The conclusion reemphasizes the need for implementing flexicurity in India, despite the financial costs associated with it.

I. The Employment Protection Legislations in India

The term 'Employment Protection Measures' refers to measures that are adopted by a State to safeguard the interests of its labour class.[6] These regulate the conditions for hiring and firing of employees; and may be grounded in legislation, collectively bargained conditions of employment, court rulings or even customary practice.[7]

According to a recent study by the World Bank, the Employment Protection Measures in India are among the most restrictive in the world.[8] On the pretext of safeguarding the interests of workers, the rigid labour laws have in fact restricted labour mobility and fostered undue State intervention. Consequently, they work to the detriment of the industrial establishments and employers in general.[9]

Thus, the following sections seek to elucidate the over-regulative character of the Indian labour laws and the resultant predicament of employers, by examining the provisions of the Industrial Disputes Act (1947), the Contract Labour (Regulation and Abolition) Act (1970) and the Trade Union Act (1926). As a solution to the existent rigidity of the Indian labour market, the author shall examine the proposition of creating a flexible system that gives multiple options to the employers to enter into different types of contracts, subject to the market volatility.

A. The Industrial Disputes Act, 1947

In pursuance of the Industrial Disputes Act, 1947[10], an employer is expected to comply with a plethora of cumbersome formalities. This section previews a few such formalities resulting from the provisions of the IDA with respect to retrenchment, lay-off and closure of an industrial establishment. Further, the author shall also examine the

6 *See Employment Protection and Labour Market Performances,* OECD Employment Outook (2000).

7 *Id.*

8 *See India Country Overview*, World Bank (2008).

9 *See* K. Basu, G.S. Fields & S. Debgupta, *Retrenchment, Labour Laws and Government Policy, available at* http://siteresources.worldbank.org/INTDECSHRSMA/Resources/india.pdf.

10 Hereinafter IDA.

stance of the Indian judiciary on whether the conditions precedent to retrenchment, lay-off and closure are opposed to the Constitutional mandate.

a. Conditions precedent to retrenchment and lay-off

In order to initiate retrenchment or lay-off proceedings, an employer has to serve a notice on the employees as well as the appropriate government, indicating bona fide reasons to this effect.[11] Furthermore, applications for retrenchment or lay-off relating to non-seasonal industrial establishments (employing more than 100 workers) must also be approved by the appropriate authority. [12]

Studies by Nagraj point out that in order to retrench even a single workman, the employer is expected to seek the permission of the labour commissioner.[13] According to Datta Chaudhari this acts as a formidable handicap, because in most cases the government does not grant the permission to retrench. Consequently, inflexibility in the free movement of labour as per demand and supply sets in.[14]

In view of this, employers have time and again questioned the constitutional validity of such provisions. The constant denial of permission by the government to retrench workers is perceived as a violation of an employer's fundamental right to carry on trade or business enshrined under Article 19 (1)(g). However even the Indian judiciary in a bid to appear pro-employee, has adopted a stance not conducive to the flexible redistribution of labour. In Workmen Compensation for *Meenakshi Mills Ltd. v. Meenakshi Mills Ltd*,[15] the Supreme Court held that the inflexible retrenchment provisions only place 'reasonable restrictions' on the employer's right to retrench workers and are therefore constitutionally valid. Thus, the Apex Court's decision serves to safeguard the welfare of the labour class even though it may potentially negatively impact the business interests of the employers.

Hence, undue state intervention in matters of retrenchment and lay-off, restrict the ability of firms to hire and fire employees according to their labour demand.

b. Conditions precedent to closure of an industrial establishment

When first introduced in 1947, the Industrial Disputes Act did not restrain employers from closing down unprofitable businesses.[16] But the amendments of the Act in 1972 and 1976 sought to provide significantly greater protection to workers than the employers.[17]

---

11 For lay-off *see* 25C and § 25M IDA; for retrenchment *see* § 25N and § 25F IDA.

12 *See* §25 N(1)(b) IDA.

13 *See* R. Nagraj, *Labour Market in India-Current Concerns and Policy Responses*, Organization for Economic Co-Operation and Development (2007).

14 *See* M.D. Chaudhuri, *Labour Markets as Social Institutions in India*, Delhi School of Economics, CDE Working Paper No. 16 (1994).

15 1994 AIR 2696.

16 *See* K. Basu, G.S. Fields & S. Debgupta, *supra* note 9.

17 *See* A.N. Sharma, *supra* note 4.

Therefore, in *Excel Wear etc. v. Union of India*[18] the Supreme Court held that the rigid provisions in the IDA as regards closure (i.e. Section 25-O) violated Article 19(1) (g) of the Constitution, and was consequently severed from the Act.[19]

In order to fill the lacuna created by the Apex Court in the *Excel Wear* case, Section 25-O was amended by the Industrial Disputes (Amendment) Act, 1982. In the current amended version closure of an unprofitable venture is permitted, however employers employing 100 or more workers must give notice of a closure to workers or their representatives and to the government, 90 days prior to the date of intended closure. A prior approval of the government is also mandatory to perpetuate a valid closure.[20]

Bhattacharjea in his thesis observes that the government invariably disallows the employers from closing down even financially unproductive industrial units, in an attempt to protect the workers.[21] He further argues that despite the amended provisions, Section 25-O still makes compliance arduous for the employers leading to greater impediments in their business decisions.[22]

This is reflected by the fact that even after the Amendment Act of 1982, the question of the constitutional validity of Section 25-O stood unresolved. The Calcutta and Karnataka High Court were of the opinion that the amended Section 25-O still violated Article 19(1)(g);[23] while the Delhi and Kerala High Court upheld its constitutional validity.[24] Finally, the controversy was put to rest once and for all by the Supreme Court in *M/s Orissa Textile and Steel Co. Ltd. v. State of Orissa and Ors.*[25] Much to the employers' dismay, the Supreme Court once again adopted a pro-worker stance and upheld the validity of the amended Section 25-O, along with its rigid compliance mechanisms. Thus in India, the government follows an ill-conceived policy of denying the closure of industrial establishments, regardless of their productivity. This consequently works to the disadvantage of the employers and negates the free operation of market forces.

---

18 (1978) 4 SCC 224.

19 The Supreme Court struck down the pre-amendment § 25-O on the following grounds: *First*, according to sub-section (2) of the pre-amendment § 25-O, the appropriate Government was not obligated to provide any justification as regards an order that denied the closure of an establishment (*See* ¶ 25 and 26). *Second*, there was no provision for appeal, review or revision of the order even after sometime (*See* ¶ 27). *Third,* on account of the first two factors, the pre-amendment § 25-O compelled the employers to pay minimum wages and to manage the undertaking, even when they did not find it financially practicable to do so. (*See* ¶26, 27 and 30).

20 *See* Section 25-0, Industrial Disputes (Amendment) Act. 1982.

21 *See* A. Bhattacharjea, *Labour Market Regulation and Industrial Performance in India: A Critical Review of the Empirical Evidence*, 39(2) Indian Journal of Labour Economics (2006).

22 *Id.*

23 Maulis of India v. State of West Bengal,(1989) 2 LLJ 400; Union of India v. Stumpp Schedule Somappa Ltd.,(1989) 2 LLJ 4.

24 DCM Ltd. v. Lieutenant Governor, AIR 1989 Del 193; Laxmi Starch v. Kundra Factory Workers Union, (1992) Lab IC 1337 (Ker).

25 2002 LLR 225.

It is further submitted that Section 9 A of the Act has also been a cause of concern for the employers. It lays down necessary pre-conditions for a change in employee service rules, whereby employees should be given at least 21 days notice before modifying their wages, hours of work and rest intervals. In the opinion of Anant this constrains industrial restructuring, technological upgrading and causes problems when employees have to be redeployed quickly in order to meet certain time bound targets.[26]

The foregoing discussion regarding the rigid provisions of the IDA highlights how the labour policies in India demonstrate a unilateral tilt towards employees. As against this, the principle assertion of the author is that instead of a partisan approach, India would do better to adopt a balanced policy framework that is mutually favorable to both the employees as well as the employer.

B. The Contract Labour (Regulation and Abolition) Act, 1970

Contract labour refers to 'workers engaged through an intermediary and is based on a triangular relationship between the user enterprises, the contractor (including the sub contractor) and the workers'.[27] The law governing contract labour in India is the Contract Labour (Regulation and Abolition) Act, 1970, and its related Rules of 1971.

The judiciary has acknowledged the significance of the Contract Labour Act by describing it as "a piece of social legislation for the welfare of labourers whose conditions of service are not at all satisfactory and the Act should therefore be literally construed".[28] The Act has considerably contributed in securing the interests of contract labourers who are generally engaged in hazardous occupations[29] and often denied minimum wages as well as employment security.[30]

However contract labour as a concept is significantly beneficial from the perspective of the employers, as it allows firms to induce flexibility in their labour structure by outsourcing certain works to a contractor or a staffing agency.[31] But due to, the recurrent judgments of the Supreme Court in 1960 and again in 1972, a number of restrictions have been placed on the use of contract labour by the employers in India. For instance, a firm cannot engage contract labour if the work is perennial, part of the core operations, involves a large number of workers or is normally done by regular workers. [32] Such

26 *See* T.C. Anant et al, *Labour Markets in India: Issues and Perspectives*, in Labour Markets in Asia: Issues and Perspectives, (J. Felipe & R. Hasan eds., 2006).

27 *See Contract Labour in India*, Ministry of Labour, *available at* http://labour.nic.in/annrep/files2k1/lab10.pdf.

28 Lionel Edward Ltd v. Labour Enforcemnt Officer, 1977 Lab IC 1037 (Cal).

29 *See Contract Labour in India*, Ministry of Labour, *available at* http://labour.nic.in/dglw/Session41ofILC.doc.

30 *See* HL Kumar, Labour and Industrial Law 509 (2d. ed. 2004).

31 *See* M. Rajeev, *Contract Labour Act in India: A Pragmatic View*, IGIDR Proceedings/ Project Report Series, PP 062 (2009).

32 Standard Vacuum Refinery Company v. Their Workmen, (1960) 3 SCR 466 ¶ 11; Vegoils Pvt. Ltd. v. Its Workmen, (1971) 2 SCC 724 ¶ 26.

limitations reduce the use of contract labour by firms, thereby augmenting the inflexibility of the labour market.

Furthermore, there also remains the issue of whether those workers who have served thus far on contract basis, must be regularized (or instead be retrenched), when the court determines that the jobs they have been doing constitute regular employment. In *Air India Statutory Corporation Ltd. & Ors v. United Labour Union & others*[33] it was held that it is mandatory for a firm to regularize the contract labour engaged in regular employment. Such a stipulation acted as a deterrent to the use of contract labour, adding to the rigidity of the labour market. Therefore, the Supreme Court overturned this position in the *Steel Authority of India Ltd. v. Union of Waterfront Workers & others*[34] by holding that a principal employer is not under any obligation as such, to absorb the contract labour working in the concerned premises.

It is worth mentioning that the judgment in the SAIL case definitely takes into consideration the broader interests of the employers. But nevertheless, it remains to be seen whether the appropriate authority will follow this judgment in letter and spirit or whether it will succumb to the vaulting pressure from the trade unions that calls for the absorption of contract labour.

C. The Trade Union Act, 1926

A trade union is defined as 'an organized association of workmen formed for the protection and promotion of their common interests, especially with regard to wages, hours and working conditions'.[35] In India, trade unions are registered under the Trade Union Act, 1926,[36] which traces its origin to the labour unrests dating back to 1877.[37] Accordingly, trade unions in India can avail themselves of different privileges and are obligated to various liabilities under the Trade Union Act.[38]

Economists like Wilkinson and Campbell acknowledge the contribution of trade unions in encouraging firms to adopt a 'high road to growth'.[39]According to Blanchflower and Oswald, trade unions also avert the 'race to the bottom' syndrome, by ensuring a minimum floor of labour standards.[40]

But over intervention by trade unions in India has earned them the title of 'market distorting agents'.[41] First, trade unions curtail the free operation of market forces leading to

33 (1997) 9 SCC 377.
34 [2001] 7 SCC 1 ¶ 89 and 125(3).
35 *See* The New International Webster's Dictionary of the English Language 1330 (Encyclopedia ed. 2003).
36 For 'Registration of Trade Unions' *see* Chapter II, § 3 to § 14 Trade Union Act, 1926.
37 *See* K.D. Srivastava, Law Relating to Trade Unions in India (2d ed. 1982).
38 For 'Rights and Liabilities of Registered Trade Unions' *see* Chapter II, § 3 to § 14 Trade Union Act, 1926.
39 *See* A.N. Sharma, *supra* note 4.
40 *Id.*
41 *See* P.L. Malik, Industrial Law 2878 (21st ed. 2008).

an increase in transaction costs which in turn, results in an alteration of the 'market price'.[42] This curtails market investments and creates a breeding ground for unemployment.[43]

Second, trade unions in consonance with the law allow for outsiders to be office bearers and members of unions.[44] So workers who are not directly employed under a particular employer also may stand against that employer in the event of any dispute. According to Nath a provision to this effect does not exist in the laws of other countries.[45]

Third, Nath points out that while countries like UK and Japan follow a democratic way of electing the office bearers of their trade unions through a process of secret ballot, laws in India follow a different strategy. [46] Election through secret ballot is not essential [47] and unions also do not hold any strike ballot before any strike.[48]

It is further argued that recurrent strikes in India are not just on account of the facilitative nature of the law. In fact, the IDA attempts to restrain strikes by mandating that employees can resort to strike only after giving a 6 week prior notice to the employers or else it would be deemed 'illegal'.[49] Further, the 'right to strike'[50] has not been recognized as a fundamental right in India, but remains a statutory right, subject to reasonable restrictions.[51] Thus, even the courts have restricted the right to strike and relegated it to the status of only a legal right. Nevertheless, India's business environment has been plagued by recurring 'illegal strikes', which have culminated in grave losses to various business establishments.[52] According to Nath the annual loss of persons per day due to strikes in India is said to be the second highest in the world.[53]

For instance in 2011, close to 700 pilots of Air India refused to fly. Consequently, 90% of their domestic flights were grounded, resulting in a loss of almost Rs. 100 crore every week to the national carrier.[54] Jet Airways also faced significant labour unrest in

---

42 *See* A.N. Sharma, *supra* note 4.

43 *Id.*44 § 22(2) of the Trade Union Act, 1926 stipulates that '*all office-bearers of a registered Trade Union, except not more than one-third of the total number of the office-bearers or five, whichever is less, shall be persons actually engaged or employed in the establishment or industry with which the Trade Union is connected* '. Thus, outsiders can be office bearers up to one third of total office bearers or five whichever is less. *See also* P.R.N. Sinha, et.al, Industrial Relations, Trade Unions and Labour Legislation (2009).

45 *See* S. Nath, *Labour Policy and Economic Reforms in India*, in B. Debroy & P.D.S Kaushik, Reforming The Labour Market (2006).

46 *Id.*

47 *See* S. Nath, *Labour Policy and Economic Reforms in India*, in B. Debroy & P.D.S Kaushik, Reforming The Labour Market (2006).

48 *See* S. Nath, *supra* note 45.

49 Syndicate Bank v. K. Umesh Nayak, 1994 SCC (5) 572.

50 *See* § 2(q)(n2) IDA.

51 All India Bank Employees Association v. IT, 1962 SCR (3) 269.

52 *See* M. Sill & R.C. Datta, *Contemporary Issues in Labour Law Reform in India: An Overview,* Tata Institute of Social Sciences, Mumbai, Discussion Paper No. 5/2007 (2007).

53 *Id.*

54 *Delhi High Court Issues Contempt Notice to Air India Pilots,* NDTV, May 3, 2011, *available at* http://www.ndtv.com/article/india/air-india-strike-hits-100-crore-mark-still-no-breakthrough-103050.

2008, when they laid-off nearly 1000 employees as a cost cutting measure in response to the rising fuel prices around the globe. Thereafter, not only did the Jet employees go on strike but also amassed enough political clout to be reinstated the very next day.[55] Therefore, it is fair to conclude that the collective bargaining machinery in India certainly restricts productivity and heightens the inflexibility of the labour market.

II. The Adverse Impact Of The Rigid Employment Protection Legislations On The Indian Business Environment

The following sections seek to establish how the inflexible labour laws in India, not only hurt the interests of the employers, but also work to the detriment of employees as well as the overall economy.

A. Effects on the Business Establishments

Studies by Papola and Datta Chaudhari have revealed that on account of the rigid Employment Protection Legislations in India, companies find it difficult to adjust the excessive supply of labour.[56] They argue that firms are forced to maintain a bloated workforce even on encountering adverse business conditions. This increases their labour costs and leaves very few resources for re-investment in new lines of activity.[57] Hence, in order to escape the rigors of rigid Employment Protection Measures, Indian companies are compelled to enforce a number of regressive policies. According to Mathur, employers have devised alternative ways to reduce the workforce despite the "restrictive" provisions in place.[58] Some policies to this effect are:

a. Excessive use of contract labour

If an employer knows well in advance that it is impossible to get the Government's permission to lay-off or retrench a permanent employee, then he would avoid getting into such a rigid commitment. Alternatively, he would choose to substitute the permanent worker with machines, contract labour or casual workers.[59] The employer may also contract out work to small enterprises which are not covered by the stringent regulations.[60]

Studies by Goswami have illustrated how the rigid labour laws have resulted in the increasing use of contract labour in the powerloom industry as well as in the already

55 *Government Examining if Sacking Flouted Law*, The Times of India, October 17, 2008, *available at* http://articles.timesofindia.indiatimes.com/2008-10-17/india/27934412_1_labour-laws-labour-ministry-labour-commissioner.

56 *See* K. Basu, G.S. Fields & S. Debgupta, *supra* note 9.

57 *See* T.S. Papola, *Structural Adjustment, Labour Market Flexibility and Employment,* 37(1) The Indian Journal of Labour Economics, NEW Delhi(1994).

58 *See* A. Mathur, Industrial Restructuring and Union Power: Micro-Economic Dimensions of Economic Restructuring and Industrial Relations in India, ILO, Geneva (1991).

59 *See* M.D. Chaudhuri, *supra* note 14.

60 *Id.*

capital intensive fertilizer and chemical industry.[61] Empirical evidence also indicates that the percentage of contract workers to total workers in the manufacturing sector as a whole increased from about 12 per cent in 1990 to about 23 per cent in 2002.[62] In states like Andhra Pradesh, the increase was phenomenal – it rose from 40 per cent in 1990 to about 62 per cent in 2002.[63] Thus, contract labour has been one of the principal methods used by the employers to gain flexibility in the labour market.

Empirical evidence has revealed that the extraordinary rise in the use of contract labour due to the rigid labour laws has been accompanied by their blatant abuse by industrial establishments. Roy has stated that in a significant number of cases where contract labour has been adopted, the workers have suffered as they have been deprived of their dues.[64] This is illustrated by the recent instances of agitation by contract workers in the Hyundai Motors case (May 2007) and the NTPC-Simhadri case (January 2007).[65] In the aforesaid cases, disconcerted contract workers had been demanding an increase in their pay scales but since the management failed to address their needs, they eventually resorted to a strike.

Thus, it can be concluded that a misuse of contract labour in India has a two-fold effect. First, by contracting out the work designed to be performed by a permanent employee, the possibility of labour specialization or firm specific knowledge in the work so contracted out, is surrendered by the firm.[66] Due to the lack of labour specialization vis-à-vis its permanent employees, a firm cannot achieve economies of scale, thereby hindering the firm's productivity.[67] Second, as pointed out by Papola and Sharma, a blinded policy of contract labour weakens the collective bargaining machinery of the labour market which in turn leads to an increase in employer militancy.[68]

b. Use of lock outs

Employers have also tried to evade the effect of the rigid labour laws by resorting to lock-outs. Nath argues that though the incidence of lock-outs has decreased since 1985,compared to other countries, India has shown a greater loss of person days.[69] According to the Economic Survey (2005-2006) the number of lock-outs in the year 2005 stood at the high figure of 185.[70]

---

61 *See* Goswami, *Sickness and Growth of India's Textile Industry: Analysis and Policy Options*, 25(31) Economic and Political Weekly(1990).

62 *See* A.N. Sharma, *supra* note 4.

63 *Id.*

64 *See* R. Dutta, *Employment Dynamics in Indian Industry: Adjustment Lags and the Impact of Job Security Regulations,* 73 Journal Of Development Economics (2004).

65 *See* M Sill & R.C. Datta, *supra* note 52.

66 *See* A.N. Sharma, *supra* note 4.

67 *Id.*

68 *See* T.S. Papola & A.N. Sharma, *Labour: Down and Out?,* Seminar (2005).

69 *See* S. Nath, *supra* note 45.

70 Ministry of Finance, *Economic Survey 2005-06,* Government of India, New Delhi (2006).

A case in point is the Murphy Electronics Company (Mumbai). The said company fearing that the Government would not grant permission to close down one of its plants, decided to use lockouts and promoted inter-union rivalries to further this cause as a tactic to get rid of workers. During the period of lockout, the management made arrangements to carry on production of its products by small sub-contractors.[71] The result was that out of the 2,500 workers only 497 remained and this strategy helped the management to get the plant declared a sick unit by the Board of Industrial and Financial Reconstruction (BIFR) in 1988.[72]

c. Other strategies and their effects

In order to combat the legislative rigidities, companies often adopt a strategy of capital deepening which involves a pure substitution of capital for labour.[73] Other strategies entail the use of golden handshakes, voluntary retirement schemes, resorting to corruption and setting up production in states where the labour class is not yet organized.[74]

The adoption of such informal routes to dismiss employees has proved detrimental to the interests of the workers. Studies by Papola and Sharma in 2005 indicate that the rigid labour laws have led to forced arrangements between local and plant level unions and employers, which have, in turn, adversely affected the welfare of the workers.[75] For example, the fear of losing jobs through informal means has impelled unions to accept relocation, downsizing, productivity linked wages, a freeze in allowances and benefits, voluntary suspension of trade union rights for a specific period etc.

A report of the Task Force of the Planning Commission in 2001 further indicates that due to the aforementioned reasons, foreign investors who are keen on investing in labour intensive countries like India are deterred from doing so.[76] The report explains that during 1991-94, the flow of foreign investments to India has gone up perceptibly, but the preferred avenue for this investment has been the financial sector, rather than manufacturing industries.[77] The fear of not being able to correct mistakes or to alter production plans in response to market signals, due to the imposed inflexibilities in labor-use is a serious deterrent to foreign investments in India.[78]

---

71 *See* K. Basu, G.S. Fields & S. Debgupta, *supra* note 9.

72 *Id.*

73 *See* A. Ghose, *Employment in Organised Manufacturing in India*, 37(2) Indian Journal of Labour Economics (1994).

74 *See* K. Basu, G.S. Fields & S. Debgupta, *supra* note 9.

75 *See* T.S. Papola and A.N. Sharma, *supra* note 68.

76 *See* Planning Commission, *Report of the Task Force for Employment Opportunities*, Government of India (2001). *See also* A. Agarawal, *The Influence of Labour Markets on FDI: Some Empirical Explorations in Export Oriented and DomesticMarket seeking FDI across Indian States* (2007), *available at* http://www.hss.iitb.ac.in/ties07/paper/ts4/psE/2.pdf.

77 *Id.*

78 *See* M.D. Chaudhuri, *supra* note 14.

B. Growth Rate of Employment In The Organized Sector

India is currently the fourth largest economy in the world,[79] having recorded a growth rate of 8.6% in GDP for the financial year 2010-2011.[80] But on account of the rigid labour laws, India's economic prowess has not been complimented by a proportional growth in employment. Employment as a whole, which had experienced a steady growth of around 2% from 1961 to 1990, declined sharply to 1.5% during 1990-92 and further to around 1% during 1993-2000.[81]

In addition, the slow growth rate of employment in the organized sector, which faced the full brunt of the rigid labour laws, is also worth considering. Between 1995-96 and 2000-01, about 1.1 million workers, or 15% of workers in the organized manufacturing sector across major states and industry groups, lost their jobs. In fact, employment in the organized sector grew at 1.2% p.a. during 1983-1994, but this rate dipped to 0.53% between 1994 and 2000.[82]

Studies by the ILO-ARTEP (1993) have analyzed the reasons behind the slow growth rate of employment in the organized manufacturing sector in India.[83] Some reasons to this effect were the increase in real wages[84] as well as structural and technological changes. But primarily they attributed the deceleration in employment growth to the inflexible labour laws.[85] A study of the Indian labour market by Ahluwalia in 1992 explained that the legal provisions surrounding job security and institutional factors such as the pressure of trade unions made the adjustment of the workforce difficult for enterprises, and hence discouraged the organized sector enterprises from expanding employment.[86]

Ahluwalia's reasoning was reaffirmed by Nagraj. In his thesis in 2004, he observed that firms in the organized sector are compelled to consider their future labour needs while devising their current employment policies.[87] Therefore, a company would be reluctant to hire additional workers during an economic upturn if it anticipates significant

79 *See Report for Selected Countries and Subjects*, World Economic Outlook Database, International Monetary Fund (2011).

80 *Advance Estimate for 2010- 2011*, Central Statistics Organization, Ministry of Finance (2010).

81 *See* A.N. Sharma, *supra* note 4.

82 *Id.*

83 *See* ILO, *India: Employment, Poverty and Labour Policies,* ILO-ARTEP (1993).

84 *See supra* note 35. 'Real wages' is defined as *'wages evaluated in terms of the purchasing power (i.e. wages that have been adjusted for inflation) as contrasted with nominal wages, evaluated in money'*. According to Fallon and Lucas (1991) and Alhuwalia (1992) an increase in the real wages is inversely proportional to the growth rate of employment in the manufacturing sector. The faster growth rate of industrial wages relative to consumer prices, abetted by job security provisions resulted in a significant long term reduction in employment during the period 1959-60 to 1985- 86; *See* A.N. Sharma, *supra* note 4.

85 *See* ILO, *supra* note 83.

86 *See* J. Ahluwalia, Productivity and Growth in Indian Manufacturing (1992).

87 *See* R.Nagaraj, Employment and Wages in Manufacturing Industries in India: Trends, Hypothesis and Evidence, Indira Gandhi Institute of Development Research, Mumbai (1993).

costs in reducing its work force during a subsequent downturn.[88] This in effect decelerates the growth of employment in the organized sector. Sharma endorses Nagraj's viewpoint and argues that excessive institutional intervention make wages 'sticky'[89] which impacts the freedom of the employers to adjust the quantities of resources allocated to wages leading to further reluctance in increasing employment. Hence, in order to protect the existing employees, the potential employees (and even retrenched workers) remain unemployed or enter the unorganized sector with no social security or political power.[90]

AN Sharma further brought to light the plight of unemployed workmen who turn to the unorganized sector. He rightly argues that employers in the organized sector would flatly refuse to employ workers from the unorganized sector. This is because employers know well in advance that at a later stage the government will refuse any application to retrench or lay-off the said workmen from the unorganized sector. Thus, the employers adopt an over-cautious approach by employing lesser workmen than their actual labour demand. Consequently, there is a visible segmentation of the market between the insiders (workers with a protected job) and outsiders (workers employed in the unorganized sector or black economy).[91] The Employment Protection Legislations clearly discourage the outsiders from entering the labour market and thereby, spur unemployment. [92]

Another study by Sundaram and Tendulkar in 2002, particularly analyzed the employment trend in the factory manufacturing sector.[93] The organized factory segment registered a higher annual average growth rate (in terms of output) i.e. 7.9% in the 1980s as compared to 4.6% during the previous decade. However, they argue that on account of the rigid labour laws, the faster growth rate of the 1980s was associated with a virtual stagnation in factory sector employment and the decade was widely described as one of "jobless growth" in the factory-manufacturing segment.

Thus, Debroy rightly argues that India's comparative advantage of enormous labour abundance would be more adequately utilized if wages in the organized sector were controlled by market forces instead of being regulated by the inflexible labour legislations.[94] In fact, Falon and Lucas have maintained that in the absence of any stringent

88 *Id.*

89 *See supra* note 35. ('Sticky wages' refers to the proposition that, "some wages adjust slowly in response to labour market sur pluses or shortages. In particular, sticky wages are prime reason behind the positive slope of the short-run aggregate supply curve. 'Sticky wages' may also be called inflexible or rigid wages").

90 *See* A.N. Sharma, *supra* note 4.

91 *See* A.N. Sharma, *supra* note 4.

92 *See* A. Barone, *Employment Protection Legislation: A Critical Review of the Literature* (2001), *available at* http://www.csifin.it.

93 *See* K. Sundaram & S. Tendulkar, *The Working Poor in India: Employment- Poverty Linkages and Employment Policy Options,* ILO, Geneva, Discussion Paper 4 (2002).

94 *See* B. Debroy, *Why We Need Law Reform* (2001), *available at* http://www.indiasemimarcom/2001/497/497%20bibek%debroy.htm.

job security regulations, the employment rate in the organized manufacturing sector would have been 17.5% higher. [95]

A survey by Besley and Burgess in 2002, examined the negative impact of 'pro-worker' laws enacted by states like Gujarat, Maharashtra, Orissa and West Bengal. [96] The study conclusively established how such anti-establishment policies had resulted in plummeting returns from the registered-manufacturing sector. On the other hand, the states with 'pro-employer' legislations (i.e. Andhra Pradesh, Madhya Pradesh, Rajasthan, Tamil Nadu, Karnataka and Kerala) had reaped the benefits of industrial deregulation. Moreover, the said observation is not just peculiar to India, but is equally applicable on the global plane.[97] For example, the higher unemployment in Europe vis-à-vis North America is often attributed to its rigid labour institutions.[98]

In a nutshell, each of the aforementioned studies and surveys provide empirical evidence to substantiate the negative consequences of the highly stringent labour laws in India.

III. Should India Adopt Labour Market Flexibility?

The foregoing discussion has established that rigid Employment Protection Legislations are counter-productive to the interests of the employers, the employees and the economy at large. The next question is whether India should adopt 'labour market flexibility', thereby giving the employers an unbridled discretion as regards the hiring and firing their employees. The following sections preview the pros and cons of an excessively flexible labour market policy.

A. Advantages of Labour Market Flexibility

The Employment Protection Index[99] indicates that countries like the United States of America and the United Kingdom have fuelled their labour markets with flexibility, as a part of the New Deal Package.[100] A study by Klapper indicates that the Chinese labour market is 3.33 times more flexible than that of India.[101] The benefits arising out of such a policy are manifested by a lower unemployment rate in the United States

95 *See* P. Fallon & R. Lucas, *The Impact of Changes in Job Security Regulations in India and Zimbabwe,* 5(3) World Bank Economic Review (1991).

96 *See* T. Besley & R. Burgess, *Can Labour Regulation Hinder Economic Performance? Evidence from India*, Journal of Economic Literature (2002).

97 *Id.;* Djankov et. al (2002).

98 *See* Nickell (1997).

99 *See Employment Protection Regulation and Labour Market Performance*, OECD Employment Outlook, Chapter 4 (2004).

100 *See The Social Security (Flexible New Deal) Regulations 2009*, Secretary of State for Work and Pensions, SI 2009 No.480 (2009).

101 *See* Klapper, Leora, L. Laeven & R. Rajan, *Barriers to Entrepreneurship*, University of Chicago, Chicago, Working Paper (2005).

America and the United Kingdom (i.e. 12.7% and 21.4% respectively), as compared to France (41.6%) and Germany (51.8%) in 2004 (which have still retained rigid labour market institutions).[102]

B. Disadvantages of Labour Market Flexibility

Needless to say, that 'labour market flexibility' is beneficial in addressing the issue of unemployment. But if there are no legal safeguards vis-à-vis the implementation of a flexible 'hire and fire' policy, then it becomes amenable to abuse by the employers. Rossen cites the example of USA to explain that with a flexible 'hire and fire' policy, the employers may lay-off their employees on a short notice, without providing any immediate financial support or other unemployment benefits like an active assistance in searching for a new job. This in turn would hinder the job and income security of the workers.[103]

For example, in 1995, the Chinese government drastically downsized many State Owned Enterprises.[104] Consequently, the number of persons that were laid-off increased from 3 million in 1993 to 17.24 million in 1998.[105] Between 1998 and 2002 another 25 million employees were laid off.[106] In spite of the mass lay-offs, the Chinese labour laws failed to provide any post-termination security to the employees.The resultant dissent from the Chinese trade unions was also suppressed by the Communist Party of China.[107] Thus, 'labour market flexibility' can serve as a double edged sword, in the absence of any supplementary social security measures.

C. An Analysis Of The Flexicurity Policy

Hence, it is asserted that a highly regulated labour market and a blinded policy of flexible 'hire and fire', represent two extreme ends of a continuum. If on one hand, the State must not arbitrarily deny the employers their right to retrench workers; then on the other hand, even the employers must not misuse the 'hire and fire' policy to the detriment of the working class. Hence, a workable strategy for India would be a hybrid of a Liberal Market Economy (and USA) and a highly Coordinated Market Economy (like India). To this effect, the following sections discuss the concept of flexicurity, which is modeled along the lines of a Negotiated Economy, and works on the central premise of harmonizing the interests of the employers and the employees.

---

102 *Id.*

103 *See* H. Rosen, *Trade Adjustment Assistance: The More We Change the More it Stays the Same, in* C. Fred Bergsten and the World Economy 79-113(M. Mussa ed., 2006).

104 J. Giles et. al, *What is China's True Unemployment Rate,* China Eco. Rev. (2004).

105 *See* J. Xue & W. Zhong, *Unemployment, Poverty and Income Disparity in Urban China*, 17 Asian Eco. J. (2003).

106 *Id.*

107 *Id.*

a. Origin of "flexicurity"

It is still disputed whether flexicurity originated in Denmark or the Netherlands. Some scholars like Van Oorschot are of the opinion that the concept was propounded by the Dutch sociologist Hans Adriaansens in the mid 1900's in connection with the Dutch Flexibility and Security Act.[108] The others contend that flexicurity originated in Denmark, after the negotiations between Danish employers and trade unions paved the way for the September Compromise (1899) and the Basic Agreement (1960).[109] The policy was formally adopted by the Danes in 1994.[110] Madsen rightly points out that flexicurity is not a political blueprint or a rational policy design but the outcome of gradual processes over time as well as political struggles and compromises.[111]

Taking a cue from the Danish flexicurity model, the European Commission has also tried to promote flexicurity among its member States. Initiatives to this effect include the Spring Summit (2006), Lisbon Strategy for Growth and Jobs (2007), Mission for flexicurity (2008), European Economic Recovery Plan (2008) and the Euro Plus Pact (2011). Furthermore, the Jobs Strategy (2006) prepared by the OECD and the Employment Sector's Decent Works Programme conducted by the ILO, have also called for an active implementation of flexicurity.

b. Definition of "flexicurity"

The concept of flexicurity guarantees a certain degree of flexibility to the employer, which is complemented by a proportionate degree of security to the working class. According to Wilthagen and Tross:

> *Flexicurity is (1) a degree of job, employment, income and 'combination' security that facilitates the labour market careers and biographies of workers with a relatively weak position and allows for enduring and high quality labour market participation and social inclusion, while at the same time providing (2) a degree of numerical (both external and internal), functional and wage flexibility that allows for labour markets' (and individual companies') timely and adequate adjustment to changing conditions in order to enhance competitiveness and productivity.*[112]

---

108 *See Balancing Work and Welfare: Activation and Flexicurity Policies in the Netherlands,* 13(1) International Journal of Social Welfare (2004).

109 *Id.*; The September Compromise (1899) refers to a series of negotiations that took place between the employers and the trade unions in Denmark to develop a Labour Market Constitution, with the underlining objective of creating a mutually beneficial state. In 1960, the said Constitution was revised and renamed the Basic Agreement. The Basic Agreement sought to curtail the unfettered autonomy in the hands of the labour class as well as the managerial prerogative to dismiss the employees arbitrarily.

110 *See* T. Wilthagen & F. Tros, *The Concept of Flexicurity: A New Approach to Regulating Employment and Labour Markets*, in *Flexicurity: Conceptual Issues and Political Implementation in Europe*, 10(2) European Review of Labour and Research (2004)

111 *See* K. Madsen, *The Danish Model of Flexicurity- A Paradise With Some Snakes,* European Foundation for the Improvement of Living and Working Conditions, Brussels (2002).

112 *See* T. Wilthagen and F. Tross, *supra* note 110.

Thus, the underlining feature of flexicurity is a trade-off between flexibility to the employers and security to the employees. To safeguard the interests of both the employers and employees, there must be proportionality between the quantum of flexibility and security on three main parameters. First, in terms of depth i.e. the extent of flexibility and security. Secon, with respect to scope, which relates to the groups that are covered through flexibility and security. And third via length, which refers to the aspect of time, i.e. whether flexibility and security occur simultaneously.[113]

It is imperative to note that different forms of flexibility and security exist in a labour market. It is the prerogative of every country to choose which form of flexibility and security is best suited to its labour market needs. Accordingly, every country should determine a suitable trade-off between the most adequate forms of flexibility and security. To take the discussion forward, let us consider the different kinds of flexibility and security that may exist in a labour market.

As per the OECD Jobs Study,[114] four different forms of 'labour market flexibility'[115] can be adopted by countries. They can be summarized as follows:

(1) External numerical flexibility allows firms to adjust the intake of labour from the external markets through relaxed hiring and firing regulations. (2) Internal numerical flexibility refers to the ability of firms to adjust the working hours of the employees. (3) Functional flexibility relates to the redeployment of the workforce within different sectors of an organization. (4) Financial flexibility refers to the wage differential between the employees on the basis of rate for the job system or assessment based pay system or individual performance wages.[116]

Similarly Wilthagen and Tross have enumerated the following forms of 'employee security':

(1) Job security is the security of being able to stay in the same job, which can be expressed via employment protection and/or tenure with the same employer. (2) Employment security refers to the security of staying employed, though not necessarily in the same job. (3) Income security relates to receiving a secured income in case of unemployment, sickness or accidents. (4) Combination security entails the possibilities available for combining working and private life, e.g. through retirement schemes, maternity leave, voluntary-sector unpaid work etc.[117]

---

113 *Id.*

114 *See The OECD Jobs Study: Facts, Analysis, and Strategies*, OECD Employment Outlook (1994).

115 *See* J. Atkinson, *Flexibility, Uncertainty and Manpower Management*, Institute of Manpower Studies, Brighton, IMS Report No.89.

116 *See* J. Berg & S. Cazes, *Policymaking Gone Awry: Labour Market Regulations of the Doing Business Indicators*, Comparative Labour Law and Policy Journal (Summer 2008).

117 *See* T. Wilthagen and F. Tross, *supra* note 110.

Thus, different countries adopt varying combinations of the aforementioned flexibilities and securities, to devise a flexicurity policy that is suitable to their labour market. For instance in Germany and Belgium, the emphasis is on more traditional forms of flexibility (i.e. working time flexibility and functional flexibility in internal labour markets), whereas the focus in both Denmark and the Netherlands is to a greater extent on numerical flexibility.[118] The same goes for the security aspect, where Germany and Belgium still tend to focus on income and job security, Denmark has shifted focus to employment security.[119]

c. The working of the flexicurity model

In order to analyze the working of the flexicurity model, this section will first discuss the Danish approach towards flexicurity, followed by the steps taken by the European Commission in this regard.

The Danish labour market policy is an interesting "hybrid" between the flexible, free market states characterized by liberal hiring-and-firing rules and the generous Scandinavian welfare regimes of high social security.[120] Thus, the Danish flexicurity model, which is referred to as the 'Golden Triangle' is often cited by most scholars in labour market literature as being an extremely effective mechanism. The 'Golden Triangle' successfully combines three core elements, i.e. an easy access to hiring and firing, generous unemployment benefits and an active labour market policy.[121]

i. Easy access to hire and fire employees

Stiglitz has stated that free market outcomes are Pareto efficient[122] and optimal.[123] Therefore, the Employment Protection Legislations in Denmark are structured along the lines of market fundamentalism.[124] Denmark has flexible and pro-employer provisions as regards the notice period and authorization before retrenchment, lay-off or closure. It

118 *See* T. Andersen & M. Svarer, *Flexicurity- The Danish Labour Market Model,* Paper Presented at the IMF Seminar on Flexicurity, Danish Central Bank(2006).

119 *See* P.K. Madsen, *Flexicurity: A New Perspective on Labour Markets and Welfare States in Europe*, Centre for Labour Market Research, CARMA Research Paper (2006).

120 *See* T. Bredgaard, F. Larsen & P.K. Madsen, *The Flexible Danish Labour Market–A Review*, CARMA Research Papers, Aalborg University, CARMA(2005).

121 *Id.*

122 *See* N. Barr, Economics of the Welfare State (2004). The 'Pareto principle' also known as the 80-20 rule, states that in most instances, roughly 80% of the effects come from 20% of the causes. The term 'Pareto efficiency' refers to a minimal notion of efficiency and does not necessarily result in a socially desirable distribution of resources. In other words, 'Pareto efficiency' makes no statement about equality, or the overall well-being of a society.

123 *See* J. Stiglitz, Globalization and its Discontents, New York, Norton (2002).

124 *See* A. Hargreaves, Teaching in the Knowledge Society: Education in the Age of Insecurity, Teachers College (2003). 'Market fundamentalism' denotes the belief in the ability of laissez-faire or free market economy policies to solve economic and social problems.

also encourages non-regular forms of employment like part-time, fixed-time, casual and contract labour. But at the same time the provisions against wrongful dismissals are strict, thus guaranteeing employment protection to the employees. In other words the employers are in a position to exercise greater leverage in hiring and firing their employees, though not arbitrarily.[125]

ii. Passive labour market policy

The high labour mobility achieved due to the flexible Employment Protection Legislations must be complimented by an efficient safety net. In view of this, the Danish Government implements passive labour market policies which seek to provide short-term income security and transition security to the unemployed workforce by granting generous unemployment benefits.[126]

First, the Danish employees pay contributions to an unemployment insurance scheme, which is partly government funded but administered by private agencies in close relations with the trade unions. Hence, a worker would receive financial security out of the unemployment insurance fund on being fired, upto a period of 4 years.[127] Moreover, the employees who are ineligible for the unemployment insurance scheme are covered under a government funded social insurance policy. This ensures that no worker is financially abandoned by the government after being served a pink slip by the employers.[128]

Second, the employers pay a lump sum amount to the employees on the termination of their job, based on the years of service. This is referred to as the severance or gratuity pay. Furthermore, according to the early retirement scheme, the Danish employers are expected to pay a lump sum or monthly payment to an employee who retires prior to his expected date of retirement.[129]

iii. Active labour market policy

The third leg of flexicurity includes lifelong activation and retraining programs for the unemployed workforce. In pursuance of this policy, the government organizes long-term programs that hone and rationalize the skills of the unemployed workers. This enhances their qualification and enables them to bag the available jobs on sheer merit. Moreover, after undergoing the training, the workers can easily be redeployed within and among different sectors of an industrial establishment. A 'carrot and stick' approach

125 *See* Campbell & A. John, National Identity and the Varieties of Capitalism: The Danish Experience (2002).

126 *See* P.K. Madsen, *Flexicurity through Labour Market Policies and Institutions in Denmark, in* P.Auer & S.Cazes, Employment Stability in an age of Flexibility (2003).

127 *Id.*

128 *Id.*

129 *See* T. Bredgaard & F. Larsen, *External and Internal Flexicurity: Comparing Denmark and Japan,* Comparative Labour Law and Policy Journal (2010).

is the defining feature of this policy, whereby any unemployed worker resisting participation in such activation programs would be flatly denied all unemployment benefits.[130]

Per the Active Labour Market Policy, the Danish Government assists the unemployed workforce in searching for a job, through an efficient public employment service. The government also provides wage subsidies that encourage employers to hire the unemployed workers and promotes self-employment through credit access and tax breaks.[131]

In a nutshell, flexicurity enables the employers to lay-off or retrench workers as per their firm's demand for labour. Thereafter, an efficient safety-net ensures that the retrenched workers immediately receive unemployment benefits from the unemployment insurance fund or in the form of severance/ gratuity pay. Moreover, if an employee remains unemployed for a longer period of time, he is enrolled in the life-long skill development program and is assisted in job search by the government. Consequently, flexicurity proves to be a positive sum game for the employer, the workers as well as the overall economy.

The European Commission has also vociferously endorsed the flexicurity policy and made constant attempts to execute flexicurity across its Member States. To this effect, the European Commission has devised the basic guidelines called the "common principles of flexicurity",[132] which serve as a barometer to prevent a lopsided implementation of flexicurity. The 'common principles of flexicurity' can be summarized as follows:

First, before implementing the policy of flexicurity each country must make ex-ante policy evaluations, to determine the long-term and societal consequences of the strategy as a whole, including its effect on institutional competitiveness. Second, each state must appropriately define the extent of flexibility and security with respect to trade-offs as well as the concrete arrangements and instruments involved in their respective flexicurity pathway. Third, the policy should be implemented through a transparent political process involving all relevant stakeholders and in an environment of trust between the public authorities and social partners. Therefore, flexicurity policies should aim to reduce the divide between the insiders and the outsiders. Fourth, flexicurity should be pursued with a view to contribute to sound and financially sustainable budgetary policies. They should also aim at a fair distribution of costs and benefits, especially between businesses, individuals and public budgets.

130 *See* T. Bredgaard & F. Larsen, *Flexicurity and Older Workers on the Danish Labour Market*, *in* Employment Policy From Different Angles, (T. Bredgaard & F. Larsen eds., 2005).

131 *See* R. Neilsen, *Flexicurity and the Lisbon Agenda: A Cross Disciplinary Reflection*, Common Market L. Rev. (2010).

132 *See Towards Common Principles of Flexicurity : More and Better Jobs through Flexibility and Security*, Commission of the European Communities Brussels (2007).

d. Empirical evidence illustrating the success of the flexicurity policy

This section examines the success of the flexicurity policy through empirical evidence from Denmark, Netherlands.

In Denmark, a successful implementation of the 'Golden triangle' has reduced unemployment and fostered a general feeling of security among the population. In 1993 the unemployment rate in Denmark was over 12% but after the formal introduction of flexicurity in 1994, unemployment has consistently declined.[133] Statistics reported by the World Economic Outlook reveal that Denmark's unemployment rate in 2011 stood at 4.1%.[134] Moreover, according to Eurostat the employment rate in Denmark in 2010 was 76.1% thereby surpassing the EU 2020 Headline Target of 75%.[135] A study by Bingley further reveals that worker turnover in Denmark is about 30% and no less than 25%.[136]

In the Netherlands, flexicurity aims to strengthen the position of workers on temporary contracts by limiting the consecutive use of fixed term contracts to three (the next contract being open-ended). This was incorporated in the Flexicurity and Security Act (1999). Consequently Netherlands saw drastic reduction of unemployment and a strong job creation. According to the statistics in 2006, employment rates in the Netherlands are high (74.3%), though employment in full time equivalents is lower due to the high part time rate.[137] The Eurostat has reported that the level of unemployment in the Netherlands is among the lowest in the Eurozone (5.1% in 2011).[138]

Studies by Aurer, the European Commission and Eichhorst and Konle – Seidl have further illustrated the successful implementation of flexicurity in Ireland, Austria and Spain respectively.[139]

e. Criticism of the flexicurity policy

A holistic analysis of flexicurity reveals that its implementation has failed to produce the desired results in certain situations. It is worth mentioning that such minor hurdles in

133 *See* J. Hendeliowitz, *Danish Employment Policy National Target Setting, Regional Performance Management and Local Delivery*, Employment Region Copenhagen & Zealand, The Danish National Labour Market Authority, *available at* http://www.oecd.org/dataoecd/13/53/40575308.pdf.

134 *See World Economic Outlook*, IMF(2011).

135 *See Labour Force Survey,* Eurostat News Release (2011), *available at http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-29062011-AP/EN/3-29062011-AP-EN.PDF*

136 *See* P. Bingley et al., *Beyond 'Manucentrism'–Some Fresh Facts about Job and Worker Flows*, Center for Labour Market and Social Research, Aarhus University, Working Paper 99-09 (2000).

137 *See supra* note 101.

138 *Euro Area Unemployment Rate 10.1%,* Eurostat News release (2011), *available at http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-07012011-AP/EN/3-07012011-AP-EN.PDF.*

139 *See* P. Aurer, *Flexibility and Security: Labour Market Policy in Austria, Denmark, Ireland and the Netherlands, in* The Dynamics of Full Employment, (G.Schmid & B. Gazier eds., 2002).

the path of flexicurity can be surmounted through effective policy execution. Nevertheless, it is imperative to discuss the criticisms leveled against flexicurity.

First, the highly dynamic nature of the labour market, involving a large number of shifts between jobs, also implies a continuous testing of the productivity of employees. Thus, due to the inadequate restrictions on the employers from conducting mass lay-offs, workers are gradually expelled from the labour market if they fail to meet the productivity criteria set by their employers. Consequently, the number of workers placed on transfer income will increase. For instance in Denmark, over the 40-year period from 1960 to 1999, the number of full-time persons receiving some form of transfer income went from about 200,000 persons to over 800,000 persons (equivalent to about one quarter of the adults aged 15-66 years).[140]

Second, Gaxier B argues that the policy of flexicurity will produce beneficial results only during a period of economic expansion, due to the high costs of funding the active and passive labour market policies. In the event of a change in the business cycle to an economic downturn, the cost of funding the flexicurity program would be difficult on account of the falling revenues. Consequently, the political pressure to cut the active programs would become overwhelming.[141]

Third, Veibrock and Clasen have relied on a number of evaluations to show examples of 'creaming effects', implying that the most resourceful among the unemployed are obtaining the best quality activation offers. Thus, the bias towards the stronger unemployed is in conflict with some of the declared political objectives of the active labour market policy.[142]

D. Can Flexicurty Be Replicated In India?

It is worth mentioning that a standard flexicurity model cannot be replicated across States as one-size-fits-all approach. There is great diversity in the social and value systems of different States, which is linked to their historical choices leading to their subsequent economic and social institutions. In view of this, the next section will argue against the replication of flexicurity in India. But the subsequent sections shall explain how India can devise a flexicurity pathway that addresses the pressing needs of the Indian labour market.

a. Problems in transferring the flexicurity policy in India

First, Schneider points out that the reforms proposed by the flexicurity model will only entail the formal economy and specifically exclude the informal sector.[143] In India

140 *See* T. Andersen & M. Svarer, *Flexicurity-The Danish Labour Market Model,* Paper Presented at the IMF Seminar on Flexicurity, Danish Central Bank (2006).

141 *See* B. Gaxier, *Flexicurity and Social Dialogue, European Ways,* Paper Presented at the DG EMPL Seminar (2006).

142 *See* Veibrock & Clasen, *Flexicurity a State-of-the-art-review*, Working Paper on Reconciliation of Work and Welfare in Europe, RECWOWE Publication Dissemination and Dialogue Centre, Edinburgh (2009).

143 *See* F. Schneider, Size and Measurement of the Informal Economy in 110 Countries around the World (2002).

the informal sector comprises a staggering 93% of the total labour force.[144] Thus, funelling budgetary finances into a high-cost flexicurity policy is futile, as the majority of the labour class will remain unaffected by these reforms. India needs to channel funds towards public works and self employment programs to uplift the informal sector rather than directing them towards the flexicurity model, which if successful would cover only 7% of the total labour force.

Second, Eichhorst and Konle-Seidl are of the opinion that strict employment protection legislations as existent in India, are hard to abolish, and Auer and Cazes point to national employment systems as considerable sources of inertia.[145] Thus, suddenly introducing the flexicurity policy may have an adverse impact on the Indian labour market. Nevertheless, it is submitted that only because the current system is hard to abolish, that fact alone does not translate into flexicurity having an adverse impact on the Indian labour market.

Third, the flexicurity model is costly because of its need to finance spending on labour market programs and unemployment benefits through the state exchequer. Consequently, higher public spending on active and passive labour market policies will be hampered by the fear of increasing the deficit on the public budgets. Moreover, financing the flexicurity model will not only increase the tax burden but also widen the tax wedge, with an adverse impact on labour demand and supply. For instance, according to an economic survey conducted by the Danish Ministry of Finance, the tax burden in Denmark was as heavy as 46.9% of GDP in 2011.[146] In view of this, a developing country like India is unlikely to effectively implement the flexicurity policy.

b. India must devise its own flexicurity pathway

The previous section has conclusively established that a number of obstacles stand in the way of executing the flexicurity model in India. But nevertheless, implementing flexicurity still remains a better option when compared to the ills associated with the existent inflexible labour market policy. The need of the hour is to devise a flexicurity policy that corresponds to the prevalent socio-political conditions in India.

Paul Vandenberg in his paper titled "Is Asia Adopting Flexicurity? A Survey of Employment Policies in 6 Countries" argues that India must implement flexicurity. He cites the example of how Asian countries like Singapore and Malaysia have modeled their brand of flexicurity according to their national requirements.[147] In Singapore and

144 Ministry of Finance, *Economic Survey 2007-08*, Government of India, New Delhi (2008), *available at* http://indiabudget.nic.in/es2007-08/esmain.htm.

145 *See* Eichhorst, Werner R.Konle-Seidl, *The Interaction of Labor Market Regulation and Labor Market Policies in Welfare State Reform*, Bonn: IZA. Discussion Paper No. 1718 (2005).

146 *See* J. Zhou, *Danish for all? Balancing Flexibility with Security: The Flexicurity Model*, IMF Working Paper, European Department (2007).

147 *See* P.Vandenberg, *Is Asia Adopting Flexicurity? A Survey of Employment Policies in 6 Countries,* Economic and Labour Market Papers, ILO, Geneva (2008).

Malaysia, weak employment protection is traded with strong lifelong skill development strategies and adequate unemployment benefits.[148]

Paul Vandenberg further illustrates how China and Korea have also undertaken a massive restructuring of their labour market on the lines of flexicurity since the past decade.[149] Currently, China and Korea are in a state of transition in implementing flexicurity. An effective implementation of flexicurity in these countries has resulted in strong labour market outcomes.[150]

Taking a cue from other Asian countries, India also needs to relax the rigid Employment Protection Legislations and contemporaneously strengthen the social security network to safeguard the interests of the unemployed workforce. In view of this, the next section discusses various proposals that could be incorporated in India's flexicurity policy.

c. Defining the contours of India's flexicurity pathway

This section seeks to illustrate how India has already initiated programs that lay down the basic groundwork for creating a sound social security network. Thus, India stands at an advantage in implementing flexicurity in a holistic perspective. But these labour market programs in India are still in their infancy, resulting in a narrow coverage, inadequate financing and tardy implementation. Therefore, in order to implement flexicurity, India needs to strike the appropriate level of trade-off between flexibility and security, coupled with an efficient enforcement and adequate financing of the existent social security schemes.

i. Strengthening programs to uplift the informal sector

The presence of a large informal sector in India is not a hurdle to flexicurity. In fact public works that strengthen the informal sector should be incorporated in India's flexicurity policy. India has implemented a number of public works programs over the years to uplift the informal sector.[151] The Mahatma Gandhi National Rural Employment Guarantee Scheme which was launched in 2006 is the most ambitious undertaking to date.

MNREGA guarantees by law each rural household 100 days of manual work annually at the statutory minimum wage of ₹120 per day in 2009 prices.[152] Thus, an average rural household working the entire 100 days would increase its income by at least $146 annually. An interesting feature of the program is that if work cannot be offered in 15 days from the time of application, then the applicant is paid an unemployment

148 *Id.*
149 *Id.*
150 *Id.*
151 *See* Maharastra Employment Guarantee Scheme(1970); National Rural Employment Program(1980), Jawahar Rojgar Yojna(1989); Employment Assurance Scheme(1993), Unorganized Workers' Social Security Act(2008).
152 http://nrega.nic.in/circular/WageRate_1jan2011.pdf.

allowance. The Central Government's outlay for the scheme is 40,000 crore in the financial year 2010-2011.[153] The scheme currently covers 625 districts across the country and according to the United Nation's Global Assessment Report 41 million households were employed in the MNREGA worksites in 2010-2011.[154]

The major criticism leveled against the adoption flexicurity in India, is that it fails to address the needs of the informal sector that employs 93% of the total Indian workforce. But this clearly stands negated if MNREGA is incorporated within India's flexicurity policy. Thus, India needs to further strengthen the implementation of MNREGA by tackling the issues of corruption, transparency and lack of awareness.

ii. Flexible laws governing the organized sector

It is worth mentioning that though the formal labour force constitutes only 7% of India's total workforce, in absolute terms it is still rather large, comprising of over 30 million workers. That is more than the entire workforce of Korea or the total workforces of Malaysia, Sri Lanka and Singapore combined. [155] Thus, there is a need to create flexible labour laws and enhance the social security for the unemployed workforce in the formal sector as well.

Part I and II of the article have conclusively established the need to do away with the highly regulative labour laws and reduce State intervention in labour market governance. Thus, India's labour laws must provide greater leverage to the employers in hiring and firing their employees.

Moreover, at present, there are 47 Central laws and 200 State laws on labour regulation in India.[156] Hence, an employer is expected to maintain a separate register for every piece of legislation and file individual annual returns per the guidelines of every Act. Eventually, most businessmen evade the high cost of procedural compliance either by bribing the inspector or paying the paltry fine imposed by the court. In view of this, the 2nd National Labour Commission, proposed the creation of an umbrella legislation (i.e. a Uniform Labour Code), enforceable across India. [157] Such a code has however not been bought into force.

iii. Passive Labour Market Policies

India has already implemented wide ranging schemes that provide unemployment benefits to the organized workforce. But these programs are rendered ineffective as a

153 *See* http://www.nrega.nic.in/netnrega/home.aspx.

154 *Global Assement Report on Disaster Risk Reduction- Revealing Risk, Redefining Development-International Strategy for Disaster Reduction*, United Nations Organization (2011).

155 *See* P.Vandenberg, *supra* note 147.

156 *See* Debroy, *supra* note 94.

157 *See Second National Commission on Labour Report*, Ministry of Labour and Employment, Government of India (2002), *available at* http://labour.nic.in/lcomm2/nlc_report.htm.

result of their insignificant coverage, slack implementation and inadequate financing. Thus, India must incorporate these schemes in its flexicurity program thereby strengthening their implementation. It is imperative to discuss some governmental initiatives in this regard.

First, the Industrial Disputes Act, 1947 and the Payment of Gratuity Act, 1972 have made provisions for the payment of a severance and gratuity amount to employees, for 15 days of wages per year of service.[158]

Second, India had allocated $73.5 million for incorporating an unemployment allowance in 2005 to its long standing Employees State Insurance Scheme. The allowance covers loss of employment due to retrenchment, closure or disability due to non-work related accidents. When initiated in 2005, the scheme covered 8.4 million workers, which represent a meager 2% of the total workforce. Thus, currently it is a relatively small program; nonetheless the inclusion of unemployment under the ESI is marked improvement and may be the basis for further expansion in the future.[159]

iv. Active Labour Market Policies

India has also initiated a number of lifelong skill development programs; nevertheless due to their small coverage and sluggish execution, they have failed to produce any significant results. Some schemes in this regard are discussed below:

First, India has undertaken a number of skills training initiatives. For instance, the government created the National Renewal Fund (1991), which was replaced by the Plan Scheme for Counseling, Retraining and Redeployment (CRR) in 2000. Other skill development schemes include the Centers of Excellence Scheme, the Skills Development Initiative and the Apprenticeship Training Scheme.[160]

Second, India operates a National Employment Service with a network of nearly 1000 'employment exchanges'. The Employment Exchanges (Compulsory Notification of Vacancies) Act, 1959, made it mandatory for the public sector and for private enterprises with 25 workers or more to register their vacancies at the nearest exchange.[161] But the failure of the scheme is reflected by a study conducted by Chandra in 2006, which indicates that in the private sector, many employers opt for non-compliance because enforcement is weak and penalties low.[162] As a result of these trends, the number of vacancies registered with the public exchanges fell by half between 1991 and 2002, while the number of placements dropped by 44%.[163]

158 *See* § 25 F (b) IDA.

159 *See* P.Vandenberg, *supra* note 147.

160 *Id.*

161 *See* P. Vandenberg, *supra* note 147.

162 *See* A. Chandra, *The Role of Training in Promoting the Objectives of the National Renewal Fund, in* National Renewal Fund: A Look Ahead (M.L.Nandrajog ed.,1999).

163 *Id.*

Third, a number of initiatives have been undertaken by the government to encourage self-employment. Initiatives to this effect include the Prime Minister's Rozgar Yojna and the Rural Employment Generation Program.[164] It is imperative to reiterate that though these schemes provide the basic framework for future expansion, as of now they are still in their infancy. Thus, the government needs to be conscious of the need to make these services more relevant when incorporating them in the flexicurity agenda.

v. The financial aspect of India's flexicurity policy

The high budgetary cost associated with the lifelong learning strategies and providing unemployment benefits is often seen as an impediment in implementing flexicurity in India. It is true that if India implements flexicurity it will require a more efficient, and sometimes greater, use of public and private resources, but this should pay off in terms of more jobs and higher labour productivity.

In this regard, while defining the 'common principles of flexicurity', the European Commission has rightly pointed out that the financial cost of flexicurity should always be assessed against the budgetary benefits stemming from enhanced labour market dynamism, higher employment and productivity.[165] The European Commission maintains that flexicurity increases labour market participation. Consequently, long-term reliance on social security benefits decrease and thereafter administrative costs can be reduced. Bassani and Duval relied on data from the OECD Member States and concluded that a 10% increase in the Active and Passive Labour Market Policy spending per unemployed person reduces by 0.4% the unemployment rate.[166]

Taking a cue from countries like Denmark and Netherlands, India must also devise ways of mutual risk management by distributing the budgetary costs of flexicurity between businesses, individuals and public budgets. Withagen suggests that a significant proportion of the on-the-job-training costs as well as the unemployment benefits can be borne by the employers and the workers. In addition, public policies may channel the financial burden towards individuals, e.g. through tax deductions.[167]

IV. Conclusion

It is high time that the Indian government walks the tightrope of balance between flexibility to the employers and security to the employees. After all, both the entrepreneur and labour are pivotal factors of production. Weighing the scales in equilibrium through flexicurity holds the key, or else one of the two factions would stand aggrieved.

164 *See* P. Vandenberg, *supra* note 147.

165 *See supra* note 132.

166 *See* Bassani & Duval, *Employment Patterns in OECD Countries: Reassessing the Role of Policies and Institutions*, 35 OECD WP (2006).

167 *See* T. Wilthagen & M. Houwerzijl, *Reconciling Labour Market Flexibility and Social Cohesion: A Methodological Tool Proposed by the Council of Europe*, Paper Presented at Forum, Council of Europe (2005).

Admittedly, transplanting the flexicurity model into the socio-political setup of India maybe a daunting task for the government, but nevertheless it is imperative to implement it. Eventually, the success of flexicurity in India would depend upon the government's willingness to implement labour reforms and the existence of mutual trust between the social partners and the State. In this regard, Abraham Lincoln had once said:

> *To secure to each labourer the whole product of labour, or as nearly as possible, is a tricky object of any good government.*

Indian Law Relating To Geographical Indications: Making New Inroads? – A Comment On Tea Board India v. ITC Limited

*Anirudh Chandrashekhar**

Abstract

Intellectual Property Law provides for the protection of a variety of entities. One such group of entities are Geographical Indications, better known as GI, which have been accorded a special status under the existing intellectual property rights regime in order to safeguard the interests, both economic and cultural, of the various communities who have cradled such GIs over a long period of time. One of the most prominent GIs existing within India is "Darjeeling Tea". The usage of this very name by a corporate entity unrelated to Darjeeling Tea in its original form forms the core dispute in the case of *Tea Board India v. ITC Limited*. This decision of a Division Bench of the Calcutta High Court (the first ever by an Indian Court with respect to GI) is sought to be analyzed in this comment. The decision assumes importance as there existed no definitive judicial authorities relating to GIs in India prior to it. The decision has also contributed to the conceptual development of GI-related offences with regard to similar concepts found in IPR, like cross category claims; as well as in other branches of law, like the tort of 'passing-off '. Finally, the decision lays down a healthy precedent by limiting the extent of control vesting with the owner of a GI, thus furthering the noble objectives behind the enactment of a specific GI-centric legislation in India.

Introduction

The term 'Intellectual Property' refers to those creations of human mind or intellect, which, although hidden, are important means of accumulating tangible wealth.[1] Intellectual property, being a form of 'property' at its very core, must be understood to be as much susceptible to abuse and misuse as other conventional kinds of property. The only difference, which arises with regard to intellectual property vis-à-vis other kinds of property, is the form and manner of such abuse. This may be witnessed on comparing the pilferage of tangible property to the duplication of intellectual property.[2] However, the latter is much more dangerous, as legitimate access to information is the backbone of intellectual property law. The moment the legitimacy of such access ceases to exist, it defeats one of the fundamental functions of intellectual property law, viz. ensuring complete control of oneself over one's own ideas, thoughts and plans. This serves as a pointer towards the fact that intellectual property law, because of its nature, is exposed

* IV Year, B.A. LL.B. (Hons.), NALSAR University of Law, Hyderabad.

1 Dr. B.L. Wadehra, Law Relating to Intellectual Property xv-xvi (5th ed. 2011).

2 *Id.* at xvi.

to various dangers and risks which can at the most be described as different from the conventional threats, which have been known to exist to property. However, shifting our attention to the silver lining to this dark cloud, we must recognize the various new domains where its provisions may be used to protect, preserve and enhance the rights of specific groups along with the general local culture. One such domain is "Geographical Indications", and this is where the instant case comes into picture.

The case of *Tea Board of India* v. *ITC Ltd.*[3] is a landmark case in the realm of intellectual property law in India, chiefly because it was the first case to be decided by an Indian Court on the issue of the infraction of a Geographical Indication[4] in India. In this case, the Calcutta High Court in addition to clearly demarcating the extent to which the proprietor of a GI could exercise control over it, also paved new paths in creation of new rights by opining and advocating the inclusion of specific rights within the scope of the provision of the laws relating to GI in India.

The chief aim of this comment is to offer a fair critique of the judgment given by the Division Bench of the Calcutta High Court in the case of *Tea Board India* v. *ITC Limited* and analyze its repercussions with regard to the laws relating to both trademarks as well as GI in India, with special emphasis on the latter, which happens to still be in its infancy. Part I seeks to enumerate a few fundamental concepts relating to GI both domestically as well as internationally; with special regard to drawing a comparison between GI and other IPR instruments. Part II serves to initiate the entire discussion around the case of *Tea Board India* v. *ITC Limited*, while dealing with the factual and argumentative matrices. Part III analyzes the Judgment while dealing with the various allied aspects dealt with by the Court like passing-off, cross-claims etc. Finally, the conclusion highlights the need for strict GI-centric laws in India, as well as the promise and potential, which the instant decision holds for the future of GI in India in specific, and of Intellectual Property Law in general.

I. The Law Relating to Geographical Indications : Concepts & Comparisons

The principal statute governing GI in India is the Geographical Indications of Goods (Registration and Protection) Act, 1999.[5] The *raison d'etre* of such a law may be understood at two levels – general and specific. On a general level, such an Act was needed to enhance the economic prosperity of the producers as well as the health and safety of the consumers of those goods, which bore an Indian GI and were being showcased in the international trade scene as top-quality products.[6] On a specific level, however, such a need was felt in order to fulfill the obligations which existed under the

3 GA No.3137 of 2010: CS No.250 of 2010.

4 Hereinafter GI.

5 Hereinafter GI Act.

6 Wadehra, *supra* note 1.

Agreement on Trade Related Aspects of Intellectual Property Rights[7] on importers of a good which, though a GI in its country of origin, was not protected under any law in that country.[8] This in turn put a reverse burden on India which was obliged under the said Agreement to protect the GI as many imported goods were protected by specific statutes[9] in their respective countries or origin; where such statutes are binding on all parties transacting in the protected product and are enforceable in any Court[10] in a member State. All these factors ultimately culminated in the enactment of the aforesaid GI law.

A. GI: Position under Indian Law

The GI Act is a unique legislation, as it completely focuses on GI, a category of goods, which had not been dealt with by any other legislation till the GI Act was brought into effect. Section 2(e) of the GI Act defines a 'Geographical Indication'. It states, *inter alia*, that such an indication aids in identifying agricultural, natural or manufactured goods as where such goods' quality, finesse or reputation can be attributed to its geographical origin. Further, it specifies that in case of manufactured goods, one or more activities out of the preparation, processing or production or such goods must occur in the geographical territory so specified.

B. GI: Position under International law

On an international level, a GI may be used for either appealing to a particular people or taste by connecting the origin of the goods in question to a particular place where such taste may reasonably be connected[11], or even for denoting that a particular product belongs to a particular trader.[12] Hence, the scope of GI under international law is wider than the scope attached to it under the GI Act in India. The rationale behind granting a GI is basically to create a global brand recognizable by its quality. This is because such brands can only result from the preservation of the distinctiveness of the concerned geographical entity.

C. GI vis-à-vis Other Instruments

The case of *Tea Board India* v. *ITC Ltd.* makes valuable contributions towards developing an understanding of the consequences, which entail on dilution and infringement of GI. This is relevant in the context of the legal provisions relating to infraction upon trade and related marks, which are both better defined (on account of there being proper precedents for the same) as well as more stringent. While the main

7 Hereinafter TRIPS.

8 Uruguay Round Agreement on Trade Related Aspects of Intellectual Property Rights, art. 24(9)(3), January 1, 1995.

9 Council Regulation (EEC) 2081/92, Jul. 14 1992.

10 Consorzio del Prosciutto di Parma v. Asda Stores Ltd, (2001) UKHL 7 (H.L.).

11 David I. Bainbridge, Intellectual Property 650 (5th Ed. 2002).

12 Montgomery v. Thompson, (1891) AC 217 (H.L.) (*Per* Lord Hannen, J.)

objective of a GI is to denote the place from where a particular *good* originates and to which place the qualitative characteristics of such *goods* may be attributed, a trademark is basically used by an enterprise in relation to *goods and services* so as to distinguish them from the others.[13] Hence, the scope of a GI is restricted when compared to that of a trademark. Further, a GI may also be distinguished from a Certification Trademark; which again is applicable to both goods and services. The provisions relating to Certification Trademarks allow for right of action where the certification trademark has been used for a *good* and the impugned trademark relates to a *service* and vice-versa. Thus, there is a scope for cross-category claims under 'certification trademark', but not so under GI and it is this fallacy, which has been effectively dealt with by the Court in the following case.

II. Tea Board India v. ITC Limited

A. The Background

The Plaintiff in this case was a statutory body[14] named Tea Board India.[15] The Board was the registered proprietor of two different certification trademarks for tea; which fall under Class 30.[16] The first of the two 'certification trademarks' was a word mark[17] for "Darjeeling"[18] and the second was a device mark[19] for an image of a lady holding two tea-leaves along with a bud in her left hand along with the word "Darjeeling" inscribed to the left of the image.[20] It may be noted that the aforementioned marks had also been separately registered by the plaintiff in 2003 under the GI Act as a GI.[21] The Board sued ITC Ltd., a premier Indian industrial house that operates many premier hotels across the country, for having named a portion of its famous luxury hotel in Calcutta, the ITC Sonar Hotel as "The Darjeeling Lounge".

Ironically, the Board came to know of the alleged infringement when ITC Ltd. applied for a trademark on the name "Darjeeling Lounge" in Class 41 when the said

13 Wadehra, *supra* note 1.

14 Formed under Section 4 falling under Chapter II of the Tea Act, 1953 as an autonomous and non profit-making enterprise.

15 Hereinafter the Board.

16 Trademarks in India are divided into 45 classes; with Classes 1-34 relating to goods (divided according to industry / area of usage) and Classes 34-45 dealing with services (divided on the basis of industry/ vocation).

17 A standardized textual or graphical representation of an entity; used for branding, identification or immediate recall of a product.

18 Trademark No. 831599.

19 A standardized trademark relating to a particular brand and including text or images synonymous with a particular brand; thereby aiding that particular brand maintain its goodwill or reputation in the market. *See* I&R Morley v. Mackey Logan Caldwell Ltd, (1921) NZLR 1001.

20 Trademark No. 532240.

21 The word and the logo were assigned GI Nos. 1 and 2 respectively; being the first GI to be applied for in India.

application was advertised in the Trademarks Journal.[22] On making enquiries, the Board came to know that the impugned Lounge was operating for a practical, commercial purpose i.e. to provide customers with food, beverages and other edible items.[23] It was, in terms of both the nature as well as conduct of its business, intrinsically a restaurant.

The Board's chief contention was that the usage of the word "Darjeeling", which was protected by a trademark by ITC Ltd. was nothing short of an infraction upon its GI mark.[24] The Board also contended that it was a direct violation of the certification trademark registered by the Board which amounted to an act of 'passing-off'[25] with respect to unfair and unwarranted competition leading to an effective dilution of the very brand value attained by Darjeeling Tea because of its status as a GI.

B. The Grounds

The Board contended that the usage of the word "Darjeeling" in the nomenclature of a particular section of a hotel being run by ITC Ltd. was done with the sole intent of cashing in upon the brand value, which was enjoyed by Darjeeling Tea, which in the first place was registered under the sole proprietorship of the Board. The Board claimed that apart from openly infringing upon the Board's GI and Certification Marks; ITC Ltd. had also indulged in "passing-off" of the aforementioned marks.[26] As a final contention, the Board also claimed that naming their lounge as "The Darjeeling Lounge" which carried out commercial activities; amounted to an action of 'dilution' of their brand, viz. Darjeeling Tea.

On the other hand, ITC Ltd. contended that the provisions of the GI Act could only be applied to *goods*, whereas the Darjeeling Lounge, which was at the centre of the entire controversy, was providing mere *services*.[27] On similar lines, ITC Ltd. also made a contention about the non-applicability of the provisions, which protect Certification Trademarks of a *good* to usage of the same mark in relation to any *service*. The third contention of the Defendants was with respect to whether the GI Act had retrospective effect, for they also claimed exemption on the ground that the hotel in dispute had been operative since 2003, before the GI Act came into force.[28]

In addition to the above, a major contention on which the Defendants heavily relied was the issue of the suit being time-barred, as the lounge in question had been

22 *Tea Board India*, *supra* note 3, at 5, ¶ 9.
23 *Id.* at 6, ¶ 10.
24 *Id.* at 9, ¶ 3.
25 *Id.* at 9, ¶ 3.
26 *Id.* at 12, ¶ 7.
27 *Id.* at 13, ¶ 8.
28 The GI Act came into force on 15th September 2003, whereas the ITC Sonar Hotel commenced operations from December 31st 2002.

within the frame of awareness of the Plaintiff Board since 2005, yet they had filed a suit five years later, i.e. in 2010.[29] The remaining two contentions of ITC Ltd. were based on questions of fact rather than of law, for they claimed that the lounge only catered to "high-end" and "exclusive" customers[30] and that it had been named "The Darjeeling Lounge" to give their customers a glance of the culinary and cultural finesse of Bengal.[31]

III. The Judgment – A Critical Foreground

A Division Bench of the Calcutta High Court, in its Judgment dated 24th August 2011, delivered by Justice Bhaskar Bhattacharya, upheld the decision passed by a single Judge of the same Court on April 20th, 2011. The Court refused to grant an Interlocutory Injunction to Tea Board India against the use of the word "Darjeeling" for the lounge run by the defendants, i.e. ITC Ltd. It is submitted that the decision of the Division Bench is sound in fact as well as in law, and may be heralded as a landmark judgment since it was the first such decision regarding a GI in India which has lucidly yet definitively settled numerous questions that arose in the course of the enforcement of the GI Act in India.

It is further submitted that the Court has also determined how far the proprietor(s) of a 'registered certification trademark' may exercise absolute control over the products so protected. Thus, the decision of the Division Bench goes a long way in removing certain ambiguities, which existed with respect to GI and other intellectual property instruments.

The Bench deliberated extensively on various aspects of the law, the most prominent amongst them being the tort of 'passing-off', which ITC Ltd. was alleged to have been indulging in. With 'passing-off' being the central argument on the side of the Board, the Bench made use of the judgment to clearly define the scope and nature of activities which would constitute the tort of 'passing-off' as well as its interplay with trademark dilution *per se*. Further, the Bench also considered the possibility of foreign decisions (in which the Board was itself a party) being applied to the present case. The final major point of law, which the Bench addressed, was the degree of control, which the proprietor of a GI could exercise by virtue of registration.

A. The Concept of 'Passing-Off'

The chief contention of the Board was that ITC Ltd. was indulging in 'passing off' amounting to unfair competition by naming their lounge as "the Darjeeling Lounge"

29 *Tea Board India*, *supra* note 3, at 13, ¶ 8.

30 *See* Tea Board India v. ITC Limited (Preliminary Judgment dated 20.04.2011) accessible at: http://www.patentindia.com/tea.pdf (Last accessed 07.04.2012), at 14.

31 *Id.* at 12, ¶ 15.

which gave the public the wrong impression that the tea served at the lounge was the same tea grown under the aegis of the Board in Darjeeling.[32] The scope of 'passing-off' under intellectual property law is quite wide and it can protect unregistered business names, unregistered trademarks, advertising or anything in general which is distinctive of the claimant's goods, services or business as a whole.[33] There is a fundamental difference between trademark infringements and passing off; as while the former requires some actual or distinct use of the said mark; the latter requires just an implied use or mention of a trade name, i.e. the latter does not require and expressly evident usage of the protected entity.[34] It can thus be safely stated that the concept of passing off is much more volatile in nature than trademark infringements. Cases like *Harrods Ltd.* v. *R. Harrod Ltd.*[35] where the Defendant named his money-lending company to "pass off" his company as having relations with the Plaintiff (which was a very respected banking company and was prohibited from money-lending because of its Articles of Association) go a long way in explaining that a mere implication of undue advantage being taken is enough to attract the provisions of the concept of "passing off".

However, in respect of this case, it is important to note that the trademarks, which were granted to the Board, were for only one substance i.e. tea. The Lounge in question served food, beverages and a host of other items of which tea was only a unitary item. Further, the Court, while considering the fact that the contention of the Board was based on the concept of 'passing off', went on to state that the basic objective behind a Defendant indulging in passing off is to portray its own goods as those of the Plaintiff.[36] The Court averred, and rightly so, that the facts of the case help us to understand clearly the fact that the Board was just a statutory body, and was not in any manner associated with the direct trade of tea, or with providing food, beverages or hospitality to people.[37] These activities were indulged in by the Defendant, i.e. ITC Ltd. Hence, no *prima facie* case of passing off one's goods as another's could be made out since both the parties engaged in totally different modes of business. The point above may also be compared to the *Harrods Ltd.* case wherein even though the two companies engaged in two evidently different activities, yet they formed a part of the same industry i.e. provision of financial services.

It was a taut observation by the Court that the registration of a 'certification trademark' was chiefly instrumental for the Board in protection of its *own* authority to undertake the certification of a beverage[38] i.e. tea, that too with respect to it having been

32 *Tea Board India*, *supra* note 24, at 12, ¶ 15.
33 Wadehra, *supra* note 1.
34 *Id.* at 651.
35 (1924) 41 RPC 74.
36 *Tea Board India*, *supra* note 3, at 18, ¶ 24.
37 *Id.* at 18, ¶ 24.
38 *Id.* at 18, ¶ 24.

produced in Darjeeling. Hence, it is a correct averment of the Court that the registration of the 'certification trademark' in essence protects the Board's authority of certification of tea and relief can be sought under such a 'certification trademark' and only if another body attempts to usurp this authority of the Board to certify.[39] Since no such attempt was made by ITC Ltd., which was quite content running hotels across India, there is in essence no scope for the application of the concept of 'passing off' against ITC Ltd. in this case.

It needs to be seen that this was not the first instance where the Board was involved in a legal dispute over improper GI usage. It had engaged in litigation earlier as well to protect the Darjeeling label, that too on foreign shores. The Bench considered as to whether the result of those cases was to be allowed to affect the present one. As such decisions involved the commercial usage of the very term in dispute, viz. "Darjeeling", a scrutiny of the same by the Bench was not just logical, but necessary.

B. Foreign Judgment Applicability

The Counsel for the Board, in an effort to further fortify his arguments, cited two foreign case-laws, both involving Tea Board India, wherein the Board had gone ahead and prevented other business entities from using the word 'Darjeeling' in their respective products.[40] In the first case, viz. *Tea Board India* v. *Jean-Luc Dusong*[41], the Paris Court of Appeal held that the registration by a French trader of a trademark name bearing the word 'Darjeeling' along with the image of a teapot was null.[42] In the second case, viz. *Tea Board of India* v. *Republic of Tea, Inc.*[43], the United States Trademark Trial & Appeal Board held that a trademark application[44] for the name "Darjeeling Nouveau" for a kind of tea served was void. The reason being that there was bound to be a lot of confusion in the minds of the general public, since both the products, however repackaged, were in actual fact the same commodity, i.e. tea.

The Counsel for the Board iterated that the abovementioned decisions would provide ample precedent to the Court for it to analyze the extent of control that Tea Board India had over the Darjeeling Tea brand. The Court's refusal to take into consideration the Judgments mentioned above, for the simple reason that such cases by virtue of not having got a chance to deal with the legislations dealing with Trademarks and GI in India[45] could not be held to be valid precedents, is thus completely justified – both legally as well as logically.

---

39 *Id.* at 18, ¶ 24.

40 *Id.* at 18, ¶ 23.

41 Case No. 05/20050 (Paris Ct. App. Nov. 22, 2006).

42 Justin Hughes & Diane Artal, *Translation of The Tea Board v. Dusong - Court of Appeals of Paris, 05/20050, Decision of November 22 2006,* 28 Cardozo Arts & Ent. L. J. 435 (2010).

43 80 USPQ2D1881 (TTAB 2006).

44 Application Serial No. 75748952, filed on July 13, 1999.

45 *Tea Board India*, *supra* note 3, at 18, ¶ 23.

The matter at hand fell within the provisions of the Trade Marks Act, 1999 on one hand and the Geographical Indications of Goods (Registration and Protection) Act, 1999 on the other (which were the governing laws for determination of disputes relating to trademarks and GI respectively in India). In this connection the Court laid proper emphasis on the Statement of Objects and Reasons which precedes the provisions of the GI Act.[46] The final sentence of the Statement reads as under:

> *… in view of the above circumstances, it is considered necessary to have a comprehensive legislation for registration and for providing adequate protection for geographical indications. Hence the Bill.*

It is crucial for us to look at the word "comprehensive" in relation to the Act. By using such a term, the Statement effectively states that the GI Act is an all-pervasive legislation, the provisions of which cover each and every aspect of GI in India. In the instant case, both the parties carry on their respective businesses in India and hence, the Court was right in rejecting the Counsel's claim for consideration of decisions which were passed by foreign Courts; as the foreign courts had not passed the Judgments according to the two Acts under the provisions of which the current matter came.

It would augur well to observe that in both the *Jean-Luc Dusong* and well as *Republic of Tea* cases, the impugned registration of trademarks was always sought only for the same product; which had been registered under the proprietorship of the Board. This cannot be said about the instant case, where ITC Ltd. was catering to a few customers by providing food, beverages and other refreshments, of which tea was just one of the items. It is submitted that this observation is essential in understanding the level of control over the Darjeeling GI, which was vested with the Board, as the same was the third major point of law, which was deliberated upon and settled by the Board.

C. To Tea or Not to Tea?

A fundamental aspect of the Calcutta High Court's decision was its disambiguation of exactly how far the right of the Board could exist over the object protected, Darjeeling Tea.[47] At this juncture, it would do us good to go through the definition of 'Certification Trademark' as given under Section 2(e) of the Trade Marks Act, 1999. It runs as follows:

> *'Certification trade mark' means a mark capable of distinguishing the goods or service in connection with which it is used in the course of trade which are certified by the proprietor of the mark in respect of origin, material, mode of manufacture of goods or performance of service not so certified and registrable as such under Chapter IX in respect of those goods or service in the name, as proprietor of the certification trade mark , of that person.*

46 *Id.* at 19, ¶ 25.
47 *Id.* at 22, ¶ 27.

The phrases "in connection with which it is used" and "in respect of those good or services in the name" signify that the provisions relating to certification trademarks apply only to those goods, which have been registered under such trademarks. Hence, it becomes clear that there was absolutely no infringement on the registered certification trademark for tea as Tea Board India possessed the certification trademark for Darjeeling Tea only with respect to certifying the tea grown in Darjeeling[48] and not with respect to set-ups operating within the scope of the Hotel industry.

It must further be noted that Section 28 of the Trade Marks Act, 1999 states that the rights conferred by a trademark are given to the registered only in relation to the goods and services for which the trademark is sought. Hence, only the rights with respect to the tea produced in Darjeeling vest safely with the Board. The Board essentially has no rights against use of the term Darjeeling in connection with something other than tea, such as a hotel lounge in this case.[49] Also, it is clear in the light of the objective of the GI Act[50], that by attempting to stop the usage of the word 'Darjeeling' (a geographic name), that too in a field over which the Board had no jurisdiction, the Board was in effect defeating the very purpose of the GI Act.[51] This is because the GI Act was enacted to give better protection to GI, not concentrate all usage of the same in the hands of a single entity. Hence, the provisions of the GI Act were also correctly held by the Court to be inapplicable in this case.

A few other aspects of the case were also decided with optimum attention paid by the Court. A path-breaking point made by the Court was that despite the GI Act being applicable solely to goods, cross-category complaints (i.e., complaints protected goods & impugned services and vice versa) *could* be initiated under Sections 22(1) (b) and 20(2) of the Act. The Act allowed prosecution against the use of any GI in a manner, which leads to unfair competition including passing off.[52] Further, it also rejected the plea of ITC Ltd. that the suit was time-barred[53]; as in spite of the suit being filed in 2010, the Board had been communicating in the form of letters to ITC Ltd., protesting communications before the Trademark Registry etc. Lastly, the Court left the question of the GI Act having retrospective effect in consequence of it holding that the Board could not take the aid of provisions of the GI Act.

---

48 *Id.* at 22, ¶ 28.

49 *Id.* at 22, ¶ 27.

50 *See* Geographical Indications of Goods (Registration and Protection) Act, 1999 ("An Act to provide for registration and better protection of geographical indications related to goods").

51 *Tea Board India*, *supra* note 3, at 22, ¶ 27.

52 *See* Explanations 1 & 2, Section 22 (1) (b), GI Act.

53 *Tea Board India*, *supra* note 30, at 12, ¶ 7.

54 Sudhir Ravindran & Arya Matthew, *The Protection of Geographical Indications in India – A Case Study on Darjeeling Tea* , International Property Rights Index – 2009 Report, Property Rights Alliance (2009).

IV. Conclusion – Paving Pathways to Certainty

Scholarly opinion suggests[54] that the protection of Geographical Indication (GI) has emerged as one of the most contentious IPR issues in the realm of the TRIPS Agreement. This statement stems from the fact that GIs, in almost all cases, embody within themselves a certain uniqueness of nature, be it through taste, aroma, texture etc. This uniqueness makes every GI susceptible to external harm and infraction. Hence, a functional legal system for the protection of GI is vital for the true realization of the commercial promise embodied within them. The landmark decision in *Tea Board India* v. *ITC Limited* is thus the proverbial stone, which kills not two, but many birds. These 'birds' are the indefiniteness of the legal status of a GI, ambiguity relating to the relationship between trademark law and law related to GI, limitations relating to the scope of rights within the GI Act (which have been dealt with the advocacy of cross-category rights) and finally, the exercise of excessive control over a geographical entity's identity. All these measures have extensively contributed to the preservation of the heart and soul of the GI Act.

This definitely paves ways for certainty regarding the inter-connection between trademark laws and laws relating to GIs in India. It has carved out a definitive understanding in relation to the extent to which control may be exercised by the proprietor in relation to his/her certification trademark. The decision has also opened a plethora of opportunities for future litigants by emancipating a ray of hope for the inclusion of cross-category rights within the GI Act. Lastly, the Calcutta High Court has protected the *raison d'etre* of the GI Act, viz. the proper registration as well as protection of GI in India by rejecting the plea of the Board, which if accepted would have created a dubious precedent with regard to the exercise of absolute control by the Board over the geographical name- "Darjeeling".

On Death, Dignity And Justice: Reflections On The Kantian Paradigm Of Capital Punishment

Anshuman Shukla[*]

Man is mortal. That may be;
But let us die resisting;
And if our lot is complete annihilation,
Let us not behave in such a way that it seems justice!

-Albert Camus[1]

Abstract

As a legal issue, capital punishment at once polarizes public debate. Arguments are advanced, both ways, on grounds as varying as retribution, deterrence and rehabilitation. Grounded in Criminology, this populist frame of reference views capital punishment as just another penal variant in law. Death, however, by its very nature, raises certain philosophical dilemmas. As a fundamental problem of philosophy, it transcends the debate of penal purpose or 'utility'. When so pursued, the endeavour is akin to asking 'the first question' on death penalty- does man deserve an improvised death? The nature of enquiry is so complex that even an affirmative to this query does not resolve the issue. It, consequently, confronts us with the next poser- is such an improvised death a moral entitlement of the society or State? Confronting this philosophical chaos, the paper studies Immanuel Kant on capital punishment. It examines his perspective on the issue and further evaluates its basis in the Kantian ethics. The discussion then shifts to the inherent contradiction- while Kant himself favoured capital punishment for grave crimes; the abolitionists of our times invoke the same Kantian construct of human dignity to seek absolute prohibition of this extreme penalty. The paper attempts to understand the genesis of this contradiction, and, in the process, offer a solution, if any.

Introduction

Forgive us, for we know not what we do in the realm of punishment.

-William E. Connolly[2]

Human endeavour is driven by a quest for perfection, yet perfection eludes our race. This paradoxical loop, however, is not a stigma. Instead of being a bleak clockwork,

* LL.M. Candidate 2013, NALSAR University of Law, Hyderabad.

1 Albert Camus, Resistance, Rebellion, And Death 26 (1997).

2 William E. Connolly, *The Will, Capital Punishment, and Cultural War, in* The Killing State- Capital Punishment In Law, Politics, And Culture 192 (Austin Sarat ed., 2001).

it implants creativity in mind and zeal in action. It informs our achievement. This unattainable pursuit is arguably the most valuable attribute of human endeavour. At its zenith, it transforms action into art.[3]

Administration of justice, then, is an art. It has engaged us since our conception. We deliberate upon its meticulous nature and evolution. Towards that end, the comprehensive compendium of Criminology and Penology that we have discerned, including various theories of justice, reflects just how intense is our desire to perfect this art. Justice delivery is certainly a noble pursuit, and perhaps the most 'human' of all- its instrumentalities are 'human' and it manifests itself in our 'human' world.

Punishment, as an element of justice, is inextricably located in this 'human' context. It has its own dilemmas and insecurities. At best, it is an imperfect art. But, as with any other human endeavour, there is nothing disgraceful about this imperfection. It only exemplifies our limits as a mortal race. Why, then, does it polarize our deliberations? If our effort is towards the noble end of justice, and if we continuously strive to perfect this art, then, ideally, we must be united in our judgment. We pursue a noble end and our intentions are equally noble. Mere fallibility in its execution is, therefore, no profound a reason to condemn ourselves.

Our deliberations on administration of justice are, then, only an effort to perfect it as an art. We are divided not on the nobility of our ends or intentions; we are divided only on the method of attaining those ends with such intentions. If this is true, then a discussion in the realm of punishment is only a quest to discern the best possible alternative of administering justice. In the process, we have come a long way. We have improved its procedure and substance, and we continue improving.

A Transcendental Detour

Capital punishment is one of the many ways in which administration of penal justice manifests itself. It is just another 'perspective' or 'proposal' for infusing efficacy in the system. A fleeting survey of the arguments promoting or condemning it, only entrenches this notion. Predominantly, we assure ourselves on the 'utility' of this extreme punishment- deterrence. When moved by higher values, we seek to ascertain a nobler 'purpose'- rehabilitation. One should, then, abolish death penalty for it injures the noble cause of rehabilitation. The utilitarian paradigms of deterrence and rehabilitation, thus, become the populist touchstones to promote or discourage the scaffold practice. This is our frame of reference and we rarely transcend it. Having invested our entire resource in this framework, we practise it with true diligence. Now, we are habituated. We think, propound and formulate for 'deterrence' or 'rehabilitation'; at best, for both.

3 By the word "art" I only intend to draw the distinction between any ordinary "action" and its superlative counterpart. One could call it by any name. I chose the word "art".

Death, however, is an inherent detour, not so much in criminology, as in ethics and political philosophy; and law is as much based in latter, as it is in former. Death, being the first philosophical problem of man, cannot be studied from the mere positivist prism devoid of the concerns of morality. However, it is an irony that the popular voices resonating in our ears have rarely produced this tone.[4]A rare few have endorsed this detour, and have deserved to earn our respect.[5] Their perspective revolves around the connotation of moral desert- death being the 'deserved' punishment in certain cases. It transcends 'utility'- deterrence and rehabilitation. Here, death is isolated from such 'extraneous' considerations. It is no more viewed as a means to some ends. The desert argument evaluates its intrinsic worth. It is prepared to advance or reject capital punishment, but solely on this ground- *for death itself*.

Death, by its very nature, raises philosophical dilemmas. It is quite often romanticized as 'judicial murder'. Its distinctiveness is reflected in the fact that one never comes across similar 'sacrilege' against other forms of punishment. When was imprisonment called 'judicial abduction'? Has restitution or compensation ever been equated as 'judicial theft'? However crude this may seem, yet it equally stirs the ethical and the rational; and sometimes, mere stirring suffices.[6]

Standing by the side of these lone voices[7], one is confronted by 'the first question'- does man deserve an improvised death?[8] Even an affirmative to this would not satisfy the rational mind. It further poses another question- is such an improvised death a moral entitlement of society or State? It is true that these questions do not form the basis of the prevailing contours of justice. But then, not always does the 'prevailing' appear as the mirror image of the 'right'. We have realised this truth from our evolution as social beings. Our reformist nature comes from this realization. It is for this reason that we challenge and reform the existing norms of our life- because quite often the 'prevailing' is not 'right'.

---

4 The populist notion of punishment is dominated by the theories of deterrence (utility) and rehabilitation.

5 Immanuel Kant and Marquis Beccaria are the leading 18th century philosophers in this genre. Intere stingly, both drew divergent conclusions on capital punishment. Yet the author of this paper is deeply moved by Albert Camus- a profound philosopher in ethics and politics. Like the other two, Camus also questions the prevailing premises of Utilitarianism and Rehabilitation. But he, being an abolitionist of our times- 20th century- deserves mention for his articulation in the essay *Reflections On The Guillotine*. Justice P.N. Bhagwati drew almost solely from Camus to render his landmark dissenting opinion in *Bachan Singh v. State of Punjab*, (1982) 3 SCC 24.

6 The author assumes that the readers would be fairly acquainted with the basic Kantian ethics. Because it is beyond the scope of this small article to capsule the entire Kantian philosophy. Kant refutes utilitarianism to say that some things are good in themselves irrespective of what end they achieve. I similarly say sometimes mere stirring of an intellectual mind "suffices". It is good in itself.

7 Kant, Beccaria and Camus, *supra* note 5.

8 Penal death is "improvised" because such death does not come "natural" to the convict.

Immanuel Kant is the 'evangelist' of the 'desert' theme. A detailed study in this 'not so popular' sphere could seek to derive gainful insight from his perspective on punishment and death. Championing the desert argument, with a retributive undertone, he acknowledges the distinctiveness of death as a mode of punishment. This alone designates him as the fulcrum of our discussion. The conclusion he derives from this standpoint is equally profound.

I. The Kantian Paradigm

Kantian ethics is the philosophical genre for which we revere Immanuel Kant. His constructs on morality, freedom and human dignity have shaped the contours of modern philosophy. As a bridge between Empiricism and Rationalism, Kant has earned the repute of an immensely original theorist. Ironically, it is the flip side of this grand biography that forms the theme of this discussion. His propositions on Law, Punishment and Justice have somehow been eclipsed by his otherwise brilliant account of "pure reason".[9] The endeavour, therefore, is to study this 'less discussed' Kantian forte. The effort is to designate it as our analytical paradigm.

A. Penal Justice: A Non-Utilitarian Model

As with his *Metaphysics of Morals*, Kant's notion of legal justice, too, is non-utilitarian. Just as he initiates his discourse on morality, freedom and dignity with a fierce criticism of Utilitarianism, so also, in his *Science of Right*[10], he anchors the legal construct of punishment and justice on his abhorrence for utility:

> *Juridical punishment can never be administered merely as a means for promoting another good, either with regard to the criminal himself or to civil society, but must in all cases be imposed* (sic) *only because the individual on whom it is inflicted has committed a crime… The penal law is a categorical imperative; and woe to him who creeps through the serpent-windings of utilitarianism to discover some advantage…*[11]

The rationale for such vehemence can be discerned in the Kantian notion of human dignity or "man as an end in himself". As a necessary corollary, a man should never be dealt with merely as a means subservient to the purpose of another. This proposition is so absolute that even a criminal has this entitlement- of being punished *for the sole reason of committing a crime and none other*. Kant articulates on behalf of the condemned man:

> *Against such treatment, his inborn personality has a right to protect him (sic), even though he may be condemned to lose his civil personality. He must first be found guilty and*

9 Kant is acclaimed for his highly original works as *Critique Of Pure Reason* and *Fundamental Principles Of Metaphysics Of Morals*. This paper is predominantly concerned with his politico-legal work *Science of Right*.

10 Immanuel Kant, Science Of Right (W. Hastie Trans.).

11 *Id.*, Part E.

punishable, before there can be any thought of drawing from his punishment any benefit for himself or his fellow-citizens.[12]

Kant furnishes an illustration beyond the classical penal utility of deterrence and rehabilitation. The idea of pardoning a criminal for the reason that he agreed to volunteer his body for medical experiments is one such concrete instance of justice being contingent upon extraneous considerations. Kant snubs this notion of justice, "for justice would cease to be justice, if it were bartered away for any consideration whatever."

B. The Criterion for Punishment

For Kant, a crime deserves punishment because it is autonomously willed against the law that we have given to ourselves as rational beings. Punishment is something the will brings upon itself by contradicting its own essence.[13] Consequently, the level of punishment must be proportional to the degree the will's disobedience contradicts its own essence.

The Kantian purpose of such discourse is to ascertain a principle of legal justice that effortlessly determines the degree of punishment for an unjust act. He proposes the equality principle for such an endeavour. In such a legal system, "the pointer of the scale of justice is made to incline no more to the one side than the other." This informs the spirit of retribution in Kantian justice:

… the undeserved evil which anyone commits on another is to be regarded as perpetrated on himself… If you slander another, you slander yourself; if you steal from another, you steal from yourself; if you strike another, you strike yourself; if you kill another, you kill yourself.[14]

This deduction is drawn from the following two premises: First, that crime is an act against the society and not just against a private individual. Second, that a criminal himself is a member of the society on which he inflicts the evil. It, therefore, follows that his action is against each member of the society, including himself. It is on such basis that the criminal must lose the membership of his society. This is the sole aim of penal justice. The delinquent is punished not for deterring the potential delinquents; nor is he spared for rehabilitation. He is punished for *he deserves it*. His criminal act is the sole basis for the consequent punitive measures.

As are his notions of morality and freedom derived from "pure practical reason", so is his idea of justice located in this theme of retribution:

… the right of retaliation (jus talionis)… is the only principle which in regulating a public court… can definitely assign both the quality and the quantity of a just penalty. All other standards are wavering and uncertain; and on account of other considerations

12 *Id.*
13 *Supra* note 2.
14 *Supra* note 10.

> *involved in them, they contain no principle conformable to the sentence of pure and strict justice.*[15]

Mere compensation cannot be a just penal measure for general and economic offences. The existing inequality in the society would then bestow an unfair advantage upon the upper class rich individuals. They could easily sustain such economic loss on their indulging in such crimes. Conversely, such a legal system would cause a relatively higher degree of suffering to a poor delinquent. The Kantian paradigm, therefore, promotes *imprisonment* as the ideal form of punishment, under standard circumstances.

He provides an illustration in the offence of theft. The right of retaliation robs a thief of all security in property- by indulging in theft, he made the property of all others' insecure. Such a criminal, then, has nothing, and can acquire nothing. Yet he has a will to live and, being bereft of all property, his existence shall now depend on the support of others- the society. This support, however, is no benevolence or gratuity. The criminal must, in return, yield his powers to the State to be used in penal labour:

> *… and thus he falls for a time, or it may be for life, into a condition of slavery.*[16]

C. Dialectic of Fatality

Retributive justice admits flexibility on account of the prevailing inequality in our society. Imprisonment, therefore, serves as model punishment for most offences. Murder, however, is one such offence where Kantian justice reinstates its 'purity' of retribution. This one offence deserves no accommodation or adjustment, whatever be the social condition. Such absoluteness on death can be directly located in the sanctity that Kant accords to human life. For him, life is not a property of the living. It is of absolute value, even under deplorable conditions. Its necessary corollary, then, would prohibit murder and suicide in the similar tone. Killing is, therefore, the gravest of all crimes. It deserves the highest and the most proportionate punishment:

> *… whoever has committed murder, must die. There is… no juridical substitute or surrogate that can be given or taken for the satisfaction of justice. There is no likeness or proportion between life, however painful, and death; and therefore there is no equality between the crime of murder and the retaliation of it but what is judicially accomplished by the execution of the criminal. His death, however, must be kept free from all maltreatment that would make the humanity suffering in his person loathsome or abominable…This ought to be done in order that every one may realize the desert of his deeds, and that blood-guiltiness may not remain upon the people; for otherwise they might all be regarded as participators in the murder as a public violation of justice.*[17]

15 *Supra* note 10.
16 *Id.*
17 *Supra* note 10.

The most radical verbalization is yet to appear. Kantian rationale for the extreme penalty is derived from the human will- "pure and practical reason". Kant suggests that even if the legal system offered the condemned man with a choice between life imprisonment and death, he would choose the latter. In an illustration of criminal conspiracy, where a few are driven by the sense of duty, for instance revolting against a tyrant, and remaining others lured by their own personal motives:

> *… the man of honour would choose death, and the knave would choose servitude. This would be the effect of their human nature as it is; for the honourable man values his honour more highly than even life itself, whereas a knave regards a life, although covered with shame, as better in his eyes than not to be.*[18]

If, then, law prescribes life imprisonment for all, it, in effect, punishes the 'honourable' more than the 'knave'. For this reason:

> *In the judgment to be pronounced over a number of criminals united in such a conspiracy, the best equalizer of punishment and crime in the form of public justice is death.*[19]

D. Whither Social Contract?[20]

Kant met a fierce counter in his contemporary, Beccaria who opposed capital punishment on its intrinsic unjustness. For Beccaria, such a punishment could not have found place in the original social contract. It cannot be presumed that people consented to their being subject to such a law because none can so dispose of his life by consenting to be killed if he murdered another.

Kant criticizes Beccaria on this account. For him, individual will is not attached to punishment but to the criminal act. Punishment falls not because the individual wills so, for then it would be no punishment at all. Instead, it is suffered because one willed the criminal act. Just as Kant makes a distinction between the individual in a *sensible world* and the individual in an *intelligible world*, so does he distinguishes the individual as one of the legislator of penal laws and the individual as the criminal himself:

> *The individual who, as a co-legislator, enacts penal law cannot possibly be the same person who, as a subject, is punished according to the law; for, qua criminal, he cannot possibly be regarded as having a voice in the legislation, the legislator being rationally viewed as just*

18 *Id.*

19 *Id.*

20 Kant's famous reconciliation of Empiricism (sensory perception) and Rationalism (intellect or reason) comes through the dualism that acknowledges the possibility of two co-existing worlds- Sensible (physical or natural) and the Intelligible (normative world of human beings governed by the norms of law, economics, politics etc.). This dualism is entrenched in his theory. In the same vein, he considers man in a dualism as both- the *recipient* as well as the *maker* of moral laws. Thus, he counters Beccaria by asserting that these two "men" are not governed by identical considerations. So it is possible for man as the "maker"to incorporate death as a punishment, even though the same man as a "receiver" may disagree.

> *and holy. If anyone, then, enacts a penal law against himself as a criminal, it must be the pure juridical law-giving reason (homo noumenon), which subjects him as one capable of crime, and consequently as another person (homo phenomenon), along with all the others in the civil union, to this penal law.*[21]

II. The Kantian Abolitionist

A discussion on death suffers from the problem of aplenty. Yet here one is confronted with a challenge qualitatively distinct. One has to be fair in evaluating Kant. Instead of invoking a different paradigm or theory, like those of utility- deterrence, rehabilitation and the likes- the endeavour must be to continue within the Kantian paradigm while questioning his propositions. Now, the Kantian paradigm hinges around *moral desert*. For him, man *deserves* death in certain circumstances. In such a framework, death transcends its legal attribute and, at once, becomes a philosophical problem. The Kantian paradigm, therefore, raises two posers: First, does man deserve an improvised death as punishment? and second,is such an improvised death a moral entitlement of the society or State?

A. The First Question

If our justice system is 'human'[22] and death has an intrinsic absoluteness, then we are doomed- the first question is unanswerable. We cannot be certain if man really deserves death as punishment in our world. This is no abstract rationalization. Since death is an inevitable phenomenon, it is truly beyond human jurisdiction. This is the precise irony of our existence. The very 'challenge' that we have not conquered, the 'challenge' which, by this very reason, becomes transcendental, we deliver the same as justice, so assured and so justified as if it were our own creation just like imprisonment or restitution.[23] Can we ever truly designate death as a punishment in the 'human' realm? The enigmatic realm of capital punishment and moral desert is discernable in the brilliant eloquence of Albert Camus:

> *The instinct of preservation of societies, and hence of individuals, requires that individual responsibility be postulated… But the same reasoning must lead us to conclude that there never exists any total responsibility or, consequently, any absolute punishment or reward. If no one can be rewarded completely… no one should be punished absolutely. The death penalty… simply usurps an exorbitant privilege by claiming to punish an always relative culpability by a definitive and irreparable punishment.*[24]

Kant faced this profound problem of transcendence, although in a more generic context of individual accountability for juridical punishment. While Camus acknowledges

21 *Supra* note 10.

22 *See* Introduction, *supra* note 2, at 3.

23 Death is transcendental because it is beyond human perfection. This is so because, in a way, each one of us is under death penalty, for we all have to die. No human endeavour dictates death.

24 Albert Camus, *Reflections on the Guillotine, in* Resistance, Rebellion, And Death 209-10 (1997).

the transcendental nature of death and so removes it out of the 'fallible' human legal jurisdiction; Kant, though, acknowledges that delinquency and the consequent culpability of a pure rational will (read "man") is beyond human to grasp, he moves beyond the human "reason and will" by invoking the religious paradigm. Thus, for him, the murderer deserves death but he is to be treated decently until the execution- "His death… must be kept free from all maltreatment…" because he is a free agent of the rational will. The offender brought the punishment upon himself by wilfully disobeying the moral law. But how does a 'pure' will develop a propensity to will evil maxims? Kant finds the source for perversion of will to be a profound and *an unanswerable question*:

> *Now if a propensity to this does lie in human nature, there is in man a natural propensity to evil; and since this very propensity must in the end be sought in a will which is free, and can therefore be imputed, it is morally evil. This evil is radical because it corrupts the ground of all maxims; it is, as natural propensity, inextirpable by human powers…*[25]

It is here that Kant is forced to invoke the Divine Intervention. Since the evil is not extinguishable or, as he puts it, "inextirpable" by human powers alone, he raises "hope" of a divine grace to enter the human will and drive away its evil maxims.[26] This recourse to grace corrupts the autonomy of will. The Kantian paradigm, thereby, comes to a dead end. Kant began with absolute faith in human reason and will. Consequently, his was a 'pure' paradigm independent of the extraneous considerations like religion, God, politics, etc. But he failed to explain the problem of evil in human actions, and here he invoked the same religious paradigm of Grace which he so wished to exclude from his philosophy. It shows how a problem that goes beyond human grasp becomes transcendental. In the similar context, death is transcendental, for there is no plausible 'human' explanation to it. This, precisely, is the absolute limitation on any criminal justice system. Camus values this ignorance or 'unknowability' and exhorts:

> *… having made up our minds never to submit and never to oppress, we should admit, at one and the same time, our hope and our ignorance, we should refuse absolute law and the irreparable judgment. We know enough to say that this or that major criminal deserves hard labour for life. But we don't know enough to decree that he be shorn of his future- of the chance we all have of making amends.*[27]

B. The Second Question

The next level of enquiry would not arise unless we have answered the first query; and we have realized just how inexplicable the first query is! Yet for the sake of completion and coherence, the second question deserves to be addressed. Let us, then, presume that

25 Immanuel Kant, Religion Within The Limits Of Reason Alone 32 (Theodore Greene and Hoyt Hudson trans.) (1960).

26 Maxim means any well-defined principle or motive on which human actions are performed.

27 *Supra* note 24 at 230.

we have determined the first poser; and not just that, let us presume that we have determined it in the affirmative- "Yes, man deserves death in punishment."

The sole objective, then, is to determine the *locus standi* of the society and State in such punishment. Can the society claim a moral standing in the penal death of a man? Can State demand death as its moral entitlement? Is death a due towards the society and State? Similar to the first enquiry, the Kantian abolitionist begs to differ from his idol- Kant- for he answers these queries in negative. Unlike Kant, he is not prepared to designate the society or State with any such moral standing. Albert Camus can be considered as the model Kantian abolitionist. As witnessed in the previous question, he operates within the Kantian paradigm of moral desert, but reaches a diametrically opposite conclusion. The basis for denying the society its moral standing is again derived from the very nature of death- an absolute and irreparable punishment. No human reward or punishment can be absolute, or else it loses the essence of 'humanity'. None of our values is absolute- not even society or State. We are a fallible and a mortal race. This is our common condition. Then, to sit on judgment to administer death is to assume a power that has not been granted to us in the first place. Our sincere abhorrence for murder is based on a moral standard- it is not for man to kill another man. Let us not invoke this abhorred act in the name of penal justice.

As the Kantian abolitionist cautions:

> *Without absolute innocence, there is no supreme judge… There are no just people- merely hearts more or less lacking in justice. Living at least allows us to discover this… Such a right to live, which allows a chance to make amends, is the natural right of every man, even the worst man… Without that right, moral life is utterly impossible... On this limit, at least, whoever judges absolutely condemns himself absolutely.*[28]

This caveat sufficiently illustrates the problematical nature of the Kantian paradigm. Yet this is no criticism to the great genius. His model has served for such a profound debate, which was hitherto least tread. Unlike the populist paradigm that conceptualizes death in an instrumentalist tone, the Kantian paradigm poses a more fundamental challenge. It abhors any extraneous purpose in death. It seeks death, *for itself*.

III. The Indian Terrain

It must be recalled here that the problem of capital punishment has a multitude of paradigms to focus upon. Even if one broadly categorizes two schools as the abolitionists and the retentionists, it is still apparent that propounders of either school have invoked such a range of varying arguments- deterrence, rehabilitation, retribution, human dignity, cruelty, irrevocability etc. In the context of law, with a plethora of legal

28 *Supra* note 24 at 221.

provisions, statutes and precedents, it becomes even more difficult to account for the 'core' paradigm that moulded the legal terrain of a specific national jurisdiction.

In this backdrop, the Indian position deserves a study so as to evaluate the degree to which it is determined by the Kant-Camus paradigm both, in theory and its 'execution' (pun intended). The case of *Bachan Singh v. State of Punjab*[29] is the watershed that shaped the Indian jurisprudence on capital punishment. For our limited objective, we can move beyond the intricacies of legal texts and the accompanying jargon. The judgment upheld the retentionist stance by 4:1 majority, with Justice P.N. Bhagwati, dissenting.

The majority, with some minor philosophical detours, remained loyal to the classical positivist paradigm of seeking solace in the legal texts. Justice Bhagwati, however, made the detour as his guiding path as he sought his answers from the most profound of voices both- ancient and modern. His dissent, therefore, maps with absolute congruency to the Kant-Camus paradigm.[30] It is reflected in his "deep and abiding faith in the dignity of man and worth of the human person and passionate conviction about the true spiritual nature and dimension of man."[31]

Justice Sarkaria, in the majority's *obiter dicta* confronts Albert Camus through the arguments advanced by Professor Jean Graven[32]. Any moral principle, according to Prof. Graven, must hold good "in troubled times as well as peaceful times". It cannot shift stance as per its own convenience. Kant's moral philosophy, too, demands a similar kind of universalism. Since Camus abhors death as a punishment in a civil society, Prof. Graven asks if Camus would hold the same for a military system or a society fighting for its survival. But this is too obscure a challenge to Camus. If Prof. Graven is pointing out, as he begins, to the inevitable "double standards" of the civil and military protection inter-se, then Camus is not confronted at all. No doubt, Camus, in his political avatar, was an anti-war campaigner, but he was not bereft of patriotism. It is out of this genuine patriotism that he beseeched his country France not to indulge in expansive wars that only brought travesties upon their own people. Camus never suggested that a country should even yield its right to self-protection. On the other hand, if Prof. Graven is concerned with that category of "monsters", as he calls them, whose extinction is a societal necessity, he comes face to face with Camus then and there alone. But, here as one studied him, Camus is not refuted by any logic. Both the thinkers have a diametrically opposite perspective on these "monsters" and the alleged "societal necessity".[33]

---

29 (1982) 3 SCC 24. 5 judges' Constitutional Bench determining the constitutional validity of capital punishment.

30 Bhagwati, J. copiously invoked several excerpts from Camus' *Reflections on the Guillotine*.

31 *Bachan Singh*, *supra* note 23, at 227.

32 The then Judge of the Court of Appeal of Geneva, *id* note 23, at ¶ ¶ 98-99.

33 Here the argument of "rarest of the rare" is invoked. Death is necessary in exceptional cases where criminals act as "monsters" and their extinction is a "societal necessity". Graven and Camus hold diametrically opposite stance on this argument and it is difficult to trump one by another. Graven endorses the "rarest

A close reading of Justice Bhagwati, however, tackles the issue with an exceptional approach. While the majority opinion is largely legalistic, his dissent acknowledges:

> *...that the question of constitutional validity of death penalty is not just a simple question of application of constitutional standards by adopting a mechanistic approach. It is a difficult problem of constitutional interpretation to which it is not possible to give an objectively correct legal answer. It is not a mere legalistic problem that can be answered definitively by the application of logical reasoning but it is a problem, which raises profound social and moral issues and the answer must therefore necessarily depend on the judicial philosophy of the Judge.*[34]

With this admission, his judgment becomes an intense philosophical study of the problem. For the limited purposes of this paper, once all the other factors- deterrence, rehabilitation, legal fetters etc.- have been filtered out, one can discern the underlying Kant-Camus paradigm in his views. Justice Bhagwati, locates the Kantian position of the individual person in the constitutional scheme:

> *Constitution is a unique document. It is not a mere pedantic legal text but it embodies certain human values, cherished principles and spiritual norms and recognises and upholds the dignity of man. It accepts the individual as the focal point of all development and regards his material, moral and spiritual development as the chief concern of its various provisions. It does not treat the individual as a cog in the mighty all-powerful machine of the State but places him at the center of the constitutional scheme and focuses on the fullest development of his personality.*[35]

The penal infliction of death, and its consequent irrevocability and psychophysical cruelty, directly injures this Kantian conception of human person. Justice Bhagwati, also renders a profound argument in this regard. While highlighting that the graded punishment, with its proportionality principle, is a logical necessity for penal laws, he asserts that graded reform is the logical necessity of a civilized society.

> *In an evolutionary society, the standards of human decency are progressively evolving to higher levels and what was regarded as legitimate and reasonable punishment proportionate to the offence at one time may now according to the evolving standards of human decency, be regarded as barbaric and inhuman punishment wholly disproportionate to the offence.*[36]

Thus the core rationale in his extensive judgment remains inspired by the Kantian paradigm, which found its noble application in the writings of Albert Camus. Since then, even though the Indian courts have rendered several pronouncements of death penalty,

cases" thesis, while Camus, as we saw in his refusal of assigning any such power to society, rejects this altogether. He supports life imprisonment as the highest possible punishment within human jurisdiction.

34 *Supra* note 29, at ¶ 229.

35 *Supra* note 29, at ¶ 235.

36 *Supra* note 29, at ¶ 265.

the actual practice reflects another tale. Statistics reveal that the actual number of executions have fallen to a negligible point; the last being as back as 2004. If that suggests the philosophical dilemma of the 'executioner', it is time to realize the virtue of dissent.

IV. Conclusion

The discussion began with two quotes[37], and they construct the theme of this paper. While one asks us to strive for justice even if our fate is sealed[38], the other wants us to acknowledge, with humility, our ignorance of the transcendental.[39] As Camus exhorts that it is not our certain end as mortals, but our approach, that determines our moral worth, so does Connolly beseech us to be mindful of our limits. Let us not seek the justification for death within our 'human' realm, for death is truly transcendental. Let us discourage a society that:

> *…proceeds sovereignly to eliminate the evil ones from her midst as if she were virtue itself… She assumes the right to select as if she were nature herself and to add great sufferings to the elimination as if she were a redeeming good.*
>
> *To assert, in any case, that a man must be absolutely cut off from society because he is absolutely evil, amounts to saying that society is absolutely good, and no one in his right mind will believe this today… Every society has the criminals it deserves… The State that sows alcohol cannot be surprised to reap crime.*[40]

Forbidding a man's execution would amount to proclaiming publicly that "society and the State are not absolute values, that nothing authorizes them to legislate definitely or to bring about the irreparable."[41] As it all began on the Kantian note- it is not our action but our intent that determines our redemption or culpability, so should it conclude. Let us hang, but with some humility.

Let the noble assassins begin...[42]

37 *Supra* note 1; *Supra* note 2.
38 *Supra* note 1.
39 *Supra* note 2.
40 *Supra* note 24 at 225-27.
41 *Supra* note 24 at 228.
42 Alphonse Karr (1808-1890), a French critic and novelist, *vide* Albert Camus, "Reflections on the Guillotine".

Judging The Remedy: An Analysis Of The Methods Employed To Solve Corporate Governance Problems

Navajyoti Samanta[*]

Abstract

Corporate governance aims to make corporations responsible, but a debate rages as to whom should such duties be owed to. Some scholars say it should be the shareholders while others contend that it ought to be the stakeholders. This article is going to trace the evolution of corporations and investigate the problems which corporate governance tries to fix and the tools used by different models of corporate governance to solve such problems. The dominant contemporary theory of Anglo-American corporate governance jurisprudence claims that non-executive directors, performance related pay for executives and market for corporate control are the solutions to most corporate governance problems. This article would examine such claims and provide a critical analysis in order to ascertain if such an assertion is true.

Introduction

In order to determine whether problems of corporate governance can be resolved by the use of non-executive directors[1], performance related pay for executives and a 'market for corporate control'[2] mechanism; it is imperative to understand the evolution of corporations and the associated development of corporate governance.

The dominant form of commercial ventures in the eighteenth and early nineteenth century was in the form of partnerships,[3] wherein the investors of capital were also the managers of the concern.[4] However, during the latter half of the Industrial Revolution in England when capital-intensive ventures like the railways, insurance, canal construction etc. began to emerged,[5] it wasn't possible for a few wealthy individuals to raise the

* LL.M. (International Commercial Law), University of Kent, Canterbury. This article was submitted by the author on Jul. 12, 2011.

1 Hereinafter NEDs.

2 Hereinafter MCC.

3 David Sugarman, *Simple Images and Complex Realities: English Lawyers and their Relationship to Business and Politics, 1750-1950,* 11 Law & Hist. Rev. 257, 274 (1993).

4 *See generally* Steven Tadelis and Jonathan Levin, *A Theory of Partnerships*, Stanford Law and Economics Olin Working Paper No. 244, October 2002 *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=311159 (last visited Apr. 28, 2011).

5 Paddy Ireland, Ian Grigg-Spall and Dave Kelly, *The Conceptual Foundations of Modern Company Law*, 14 J.L. & Soc'y 149, 159 (1987); *See also* Paddy Ireland, *Capitalism without the Capitalist: The Joint Stock Company Share andthe Emergence of the Modern Doctrine of Separate Corporate Personality* 17 J.l of Leg. Hist. 40, 49 (1996). It is to be noted that the first JSCs in English legal system originated in the 14th century, however incorporating a company needed Royal Charter and were thus few in number compared to the number of JSCs in the aftermath of passing of Companies Acts of 1844-62. *See* Brian R. Cheffins, Corporate Ownership and Control British Business Transformed (2008).

required funds alone.[6] This gave rise to the concept of a Joint Stock Company[7] wherein many investors would pool their resources.[8] The major advantages of a JSC over a partnership are that the liability of shareholders is limited to the extent of their unpaid share capital,[9] and the company has a distinct and continuous legal identity insofar as it can take and grant property in addition to being able to sue and be sued in its own name.[10] However, the greatest advantage of a company was the free transferability of its shares.[11] Thus unlike partnerships, where sale of equity by individual partners was almost impossible without the assent of others partners, a JSC shareholder would be able to sell the shares without much restriction in the share market.[12]

Due to the free transferability of shares and the high capital requirement of JSCs, the number of shareholders increased rapidly.[13] Commenting on the rush to purchase shares of railway companies in the mid 19th century, poet William Wordsworth observed, "From Edinburgh to Inverness the whole people are mad about railways. The country is an asylum of railway lunatics."[14] One of the fallouts of such dispersed and diffused shareholding was the emergence of professional managers who had little shareholding in the company and yet would dominate the board of directors in effect running the company 'on behalf of the shareholders'.[15] Emergence of these professional directors as managers of company's assets widened the distance between shareholder ownership and control of the company, effectively morphing shareholders into 'sleeping partners' or 'rentier investors' whose main objective was to gain maximum profit from their investment.[16] With the advent of institutional investors along with rapid financialization

6 *See generally* Richard Brown, *Genesis of Company Law in England and Scotland*, 13 Jurid. Rev. 185 (1901).

7 Hereinafter JSC.

8 James C. Finney, *Corporations*, 10 U. Det. Bi-Monthly L. Rev. 107, 109 (1926-1927).

9 Thus in case the company goes bankrupt and needs to satisfy its creditors, the shareholders would be legally obliged to pay only to the extent of unpaid share. *See* section 3 of Companies Act 2006. While in partnership every partner in firm is liable jointly and severally with the other partners for all debts and obligations of the firm incurred while he is a partner. *See* § 9 of Partnership Act 1890.

10 *See* Salomon v A Salomon & Co Ltd [1897] AC 22 for position in UK and Berkey v. Third Avenue Railway Co 244 N.Y. 602 (1927) for position in USA. In a partnership the firm does not exist as a separate legal entity acts of a partner binds the firm and through it the other partners. *See* §§ 5 and 6 of Partnership Act 1890. Further unlike companies which have continuous and perpetual existence, a partnership firm would dissolve merely if one of the partners dies unless there is an agreement to the contrary. *See* § 33 ofPartnership Act 1890.

11 *See* Avord v Smith 5 Pickering 232 (1827) as cited in Hugh L. Sowards and James S. Mofsky, *Factors Affecting the Development of Corporation Law*, 23 U. Miami L. Rev. 476, 477 (1968-1969) for position in USA. For historical overview of change of character of share in UK *see* Ireland (1996), *supra* note 5.

12 Finney, *supra* note 8, at 110.

13 Paddy Ireland, *Property and Contract in Contemporary Corporate Theory*, 23 Leg Stud 453, 461-462 (2003); *See* P. L. Davies, Gower's Principles of Modern Company Law (8th ed 2008) ch 2, 3; J. H. Farrar & B. Hannigan , Farrar'sCompany Law (4th ed. 1998).

14 As quoted in Cheffins, *supra* note 5, at 160.

15 Christopher A. Riley, *Understanding and Regulating the Corporation*, 58 Mod. L. Rev. 595, 595, 609 (1995).

16 *See generally* Adolf Berle & G. C. Means, The Modern Corporation and Private Property (2d revised ed. 1991); Adolf Berle, *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049 (1931); Edwin M. Dodd, *For whom are*

in the last quarter of the 20th century, in addition to the ascendancy of a neoliberal econ-political ideology in the 1970s, the main thrust of the directors of companies was removed from increasing overall productive output to increasing the market capitalisation of the company.[17] At present, neoliberal shareholder oriented corporations are the dominant form of companies in the Anglo-American business sphere.[18]

Corporate governance as academic discourse arose due to the widening rift between the shareholders and the management of the company.[19] Richard Eells in 1960 coined the term 'corporate governance' and described it as 'the structure and functioning of the corporate polity.'[20] Since then the focus and function of corporate governance has varied according to the legal, economic or political philosophy and outlook of the scholar. Christine A. Mallin differentiates the competing definitions of 'corporate governance' on the basis of "whether the company itself operates within a shareholder framework, focusing primarily on the maintenance or enhancement of shareholder values as its main objective, or whether it takes a broader stakeholder approach, emphasising the interests of diverse groups such as employees, providers of credit, suppliers, customers, and the local community."[21] Thus there are two major opposing frameworks which dominate the corporate governance viewpoint – shareholder primacy and the stakeholder theory.[22]

Mallin explains the stakeholder theory in the context of a company, which 'takes account of a wider group of constituents rather than focussing on shareholders.'[23] She adds 'where there is an emphasis on stakeholders, then the governance structure of company may provide for some direct representation of the stakeholder groups.'[24] The philosophical underpinnings of the stakeholder theory lie in the complete separation of the control and ownership of a company.[25] The supporters of this theory try to prove that shareholders no longer own or control the company economically or legally.[26] The logical conclusion to such an assertion would be a 'socially responsible corporation', which is not just aligned to the interests of the shareholder but would also 'use the power

Corporate Managers Trustees?, 45 Harv. L. Rev. 1145 (1932); Adolf Berle, *For whom Corporate Managers are Trustees:A note*, 45 Harv. L. Rev. 1365.

17 *See* David Harvey, A Brief History of Neoliberalism (2005); Financialization and the World Economy (Gerald A. Epstein ed., 2005); Ismail Erturk et al, *General introduction: Financialization, coupon pool and conjuncture*, *in* Financialization at Work (Ismail Erturk et al ed. 2008).

18 Henry Hansmann and Reiner Kraakman, *The End of History for Corporate Law* 89 Geo. L. J. 439 (2000).

19 *See* John H. Farrar, *A Brief Thematic History of Corporate Governance*, 11 (2) Bond L. Rev. 259 (1999), *available at* http://epublications.bond.edu.au/blr/vol11/iss2/9 (last visited April 28, 2011).

20 Richard Eells, The Meaning of Modern Business: An Introduction to the Philosophy of Large Corporate Enterprise (1960) 108 as cited inUdo C. Braendle and Alexander N. Kostyuk, Developments in Corporate Governance (2007).

21 Christine A. Mallin, Corporate Governance 13 (3d ed, 2010).

22 Robert Wearing, Cases in Corporate Governance (2005).

23 Mallin, *supra* note 21, at 18.

24 *Id.* at 21.

25 *See* Berle & Means (1932), *supra* note 16; Ireland (1996), *supra* note 5.

26 *See* Berle-Dodd debate, *supra* note 16.

of business to solve social or environmental problems.'[27] The proponents of the stakeholder theory argue that a socially responsible corporation would achieve long-term profitability[28] instead of short-term myopic gain.[29]

On the other hand, the shareholder primacy theory rests the foundation of its argument on the agency theory. Under this theory the corporation is viewed as a nexus of contracts,[30] wherein as per the contractual relationship, the shareholders are principals while the managers are their agents whose sole aim is to increase the corporation's profits.[31] Therefore, under the agency theory, managers (agents) should act in the best interest of their principal (shareholders).[32]

Upon this understanding of the different models of corporate governance, let us revisit the original question raised in the beginning of this article as to whether the use of NEDs, performance related pay for executives and 'market for corporate control' would solve corporate governance problems effectively. In order to resolve this query, in Part II of this article the author would discuss separately the problems of corporate governance, which the two different models seek to solve. For the shareholder primacy model the identified governance, shortcomings would be agency problems like misuse of power by managers, mismanagement of company, oppression of minority shareholder etc. Under the Stakeholder model the risk of losing human capital, short term versus long-term profitability, effect of corporations on the community at large etc. would be the problems discussed. In Part III, the solutions to the governance problems identified under the shareholder primacy model as per the Anglo-American corporate governance framework and OECD Principles of Corporate Governance, namely the use of NEDs, performance related pay for executives, and the operations of market for corporate control would be explained and examined. In Part IV, solutions like dual board, employee participation etc., evolved by scholars and institutions under the stakeholder model will be discussed with specific reference to the Indian context. Finally, in Part V, the effectiveness of the Anglo-American solutions to corporate governance problems would be critically analysed in order to ascertain if they solve any and/or all forms of corporate governance problems.

---

27 Rakhi I. Patel, *Facilitating Stakeholder-Interest Maximization: Accommodating Beneficial Corporations in the Model Business Corporation Act* 23 St. Thomas L. Rev. 135, 137 (2010).

28 David *Novick*, '*Cost-Benefit Analysis in the Socially Responsible Corporation*', in Managing the *Socially Responsible* Corporation (Melvin C. Ahnsen ed., 1974) as cited in Robert B. Reich, *Corporate Accountability and Regulatory Reform*, 8 Hofstra L. Rev. 5, 31 (1979-1980).

29 M. M. Blair, Ownership And Control: Rethinking Corporate Governance For The Twenty-First Century 13 (1995).

30 M. C. Jensen and W. H. Meckling, *Theory of the Firm: Managerial behaviour, Agency costs and ownership structures* , 3 J. of Fin. Eco. 305 (1976).

31 Milton Friedman, *The Social Responsibility of Business is to Increase its Profits,* The N.Y. Times Magazine, Sep. 13, 1970.

32 Mallin, *supra* note 21 at 14-15.

I. Problems Identified By Corporate Governance Framework

A. Shareholder Primacy Model

The main governance problems identified in the shareholder primacy corporategovernance framework is that of agency and the related agency costs.[33] In his seminal book "The Wealth of Nations" Adam Smith laid the foundational setting of the agency problem as:

> [*B*]*eing the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. [...] Without an exclusive privilege, they have commonly mismanaged the trade. With an exclusive privilege, they have both mismanaged and confined it.*[34]

Based on this ideological setting Micheal Jensen and William Meckling[35] identified the 'relationship between the stockholders and managers of a corporation' as "a pure agency relationship."[36] However, to curtail the self-seeking motive of agents, every agency relationship would entail some 'agency costs', which Jensen and Meckling expounded as: the monitoring expenditure by the principal, the bonding expenditures by the agent, and the residual loss.[37]

Therefore, in an agency setting the problems of a widening rift between ownership and control is an irrelevant concept.[38] What matters is the reduction of the agency problem by making the managers fully accountable to shareholders.[39] Thus the aim of corporate governance based on the 'agency theory' motif is to ensure that the agents seek to maximise the welfare of the principal, rather than their own.[40] This can be ensured 'through incentives that seek to align the agent's interests with those of the principal, and through monitoring that enforces the principal's interests."[41]

---

33 Stuart Chan, *Corporate Agency Costs - An Unresolved Problem*, 7 Inter Alia 102 (2010).

34 *See* Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations (1776) Book V, Ch.1, Para 18 of the Expenses of the Sovereign or Commonwealth.

35 *See* Jensen and Meckling, *supra* note 30.

36 *Id.* at 319.

37 *Id.*

38 In an agency model it is expected that there would be a ownership-control gap between the principal (shareholder) and their agent (managers). *See* Eugene Fama, *Agency Problems and the theory of the form*, 88 J. of Pol. Eco. 288, 304 (1980).

39 Virginia Harper Ho, *Enlightened Shareholder Value: Corporate Governance beyond the Shareholder-Stakeholder Divide*, 36 J. Corp. L. 59, 108 (2010-2011).

40 John Roberts, *Trust and control in Anglo-American systems of corporate governance: The individualizing and socializing effects of processes of accountability* 54 (12) Human Relations 1547, 1548 (2001).

41 *Id.*

B. Stakeholder Model

In contrast to the shareholder primacy model whose sole focus is on shareholder value maximisation, the stakeholder model addresses 'who or what really counts'.[42] It thus encompasses the interests of a wide range of stakeholder groups like investors, employees, suppliers, customers and managers – but cannot be equated with any one of them.[43] Thus, the stakeholder model is based on a trusteeship model,[44] wherein 'businesses are defined as a nexus of long established trust relationships'[45] and managers act as trustees to sustain assets of the corporation to benefit all stakeholders. The theoretical backing to this model derives itself from the assertion that assets of the corporation include not just the capital provided by shareholders but also the 'skills of its employees, the expectations of customers and suppliers, and the company's reputation in the community.'[46]

Thus, the problems, which the stakeholder model seeks to solve, are multifaceted and diverse owing to the divergent and sometimes competing interests of the stakeholders. They may range from low employment morale, management apathy, undesirable effects on community, non-standardised multiple products to predatory business practices, tax avoidance, opaque policy objectives, adverse consequence on the environment, collusion with oppressive government regimes which do not respect human rights of their citizens etc.

The stakeholder model aims to solve these problems through a cooperative relationship involving the participation and consultation of all the interested stakeholders.[47] It also emphasises on intergenerational equity where the interests of future customers and employees are taken into consideration in the long-term development of the capabilities of the business.[48] Thus the stakeholder model seeks to implement responsible management behaviour in order to maximise the welfare of its stakeholders even at the cost of adopting certain constrains to profits.[49]

However, unlike the shareholder profit maximisation theory, which has a clear objective for managers to aim solely at providing maximum returns on shareholder investment, in stakeholder welfare maximisation there is confusion as to how to best balance the competing needs of stakeholders. As Easterbrook and Fischel observed:

> *[A] manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither. Faced with a demand from either group, the manager can appeal to the interests of the other. Agency costs rise and social wealth falls.*[50]

42 R. Edward Freeman, Strategic Management: A stakeholder approach (1984).
43 John Kay, *The Stakeholder Corporation* in Stakeholder Capitalism 126 (Gavin Kelly et al. ed., 1997).
44 *Id.* at 134.
45 *Id.* at 135.
46 *Id.*
47 Kent Greenfield, *Defending Stakeholder Governance*, 58 Case W. Res. L. Rev. 1043 (2007-2008).
48 Kay, *supra* note 43 at 136.
49 John Parkinson, *Company Law and Stakeholder Governance* in Stakeholder Capitalism 148 (Gavin Kelly et al. eds., 1997).

However such a criticism may be resolved if the stakeholder model, similar to the shareholder model, insists that the corporation maintain a transparent record of its financial, legal and business decisions. But unlike the shareholder model which uses transparency to make managers accountable to shareholders, the stakeholder model may use transparency to make managers accountable to all stakeholders.

II. Solutions Under Shareholder Primacy Model

As has been discussed earlier, once a corporation has been reduced to a nexus of contracts under the shareholder model and the relationship between shareholders and managers is classified as a principal-agent relationship, the solution to the problems of corporate governance is condensed into 'how best to align the interest of managers with that of shareholders', which is understood to be maximum return on invested capital.[51] The Anglo-American corporate governance model, which has evolved under the umbrella of the shareholder primacy theory, provides for use of NEDs, performance related pay for executives, and the operations of market for corporate control as ideal corporate governance platforms.[52]

A. Non Executive Directors

Under the Anglo-American corporate governance model, companies have a unitary board structure where the executive directors,[53] elected by shareholders, take decisions on how to run the company. However in order to ensure that executive directors work in the best interest of the shareholders, the Anglo-American model puts in a separate set of independent NEDs[54] to oversee the functioning of the executive directors. The most

50 Frank H. Easterbrook And Daniel R. Fischel, The Economic Structure Of Corporate Law 38 (1991) as cited in Ho, *supra* note 39.

51 *See generally* Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. of Cor. L. 63 (2006).

52 *See generally* Ismail Erturk et al, *Corporate Governance and impossibilism* 1 (2) J. of Cul. Eco. 109 (2008); Thomas Clarke, *A critique of Anglo-American model of Corporate Governance* (2009) 5 (3) CLPE Research Paper 15; for acritical background history of growth of Anglo-American Corporate Governance model *see* Mark Roe, *A Political Theory of American Corporate Finance* 91 Colum. L. Rev. 10 (1991).

53 UK Companies Act 2006 does not differentiate between executive and NEDs, section 250 of the Act defines directors as 'any person occupying the position of director, by whatever name called.' However an executive director can be described as a 'director [who] will normally have some day-to-day responsibility for the running of the company's business. The term 'executive' has no precise legal meaning but is derived from the idea that the director has some specific executive tasks and authorities delegated to him or her by the board of directors. Executive directors will normally be employees of the company and benefit from service contracts. The director's rights and obligations under a service contract have a largely separate existence from his or her legal rights and obligations as a director. If a director resigns or is dismissed as a director, the terms of a service contract will continue to apply until it expires or is terminated.' Neil Harvey and Ian Yeo, *Duties and Liabilities of Directors of a Private Limited Company under English Law*, Int'l Bus. L.J. 749, 750 (1996).

54 'The listing rules of the Stock Exchange of Hong Kong Ltd. define the independent NEDs as: first, an independent non-executive director does not have the administrative or management responsibilities in a company, that is, he/she does not participate in the routine operation of the company; nor does he/she participate in the management. Second, an independent non-executive director must be independent of

common grounds for use of NEDs are to 'give access to relevant external information, provide an independent appraisal and check on management, strengthen the board, give new perspective on the company direction etc.'[55] As per the Cadbury Report, NEDs are supposed to bring 'independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.'[56] To ensure that NEDs are truly *independent*, the Cadbury Report suggested that NEDs should not have 'any business or other relationship with the company concerned, which could materially interfere with the exercise of their independent judgement.'[57] However, the report was ambivalent as to the remuneration of NEDs.[58] The Cadbury Report has since formed the basis of every corporate governance reform, which followed the Anglo-American path, around the world.[59]

Eleven years after the Cadbury Report, in 2003 the Department of Trade and Industry, UK promulgated a review on the role and effectiveness of NEDs, which came to be known popularly as the Higgs Report.[60] It divided the role of NEDs into four broad focus areas: 1) to contribute to the development of strategy of the company (strategy), 2) to scrutinise the performance of the management in meeting agreed goals and objective (performance), 3) to inspect and audit the financial reports and verify that the risk management system is robust (risk) and lastly 4) to contribute to the appointment of senior management, succession planning, determine remuneration of executive directors etc. (people).[61] The Higgs Report concluded that there was "no essential contradiction between the monitoring and strategic aspects of the role of the non-executive director."[62] It also laid down objective criteria for determination of the independence of NEDs which included requirements along the lines of the person not representing a significant shareholder, holding cross-directorships, or receiving additional remuneration from the company etc.[63] The Higgs Report also proposed that NEDs

the management, without any direct relations with the management. For instance if a person has relatives in the management of a company, such person is not qualified to be an independent non-executive director of the company. Third, an independent non-executive director does not have any interests otherm than the remuneration paid by the company.' Moses Mo-Chi, *Role of Independent Non-Executive Directors available at* http://www.cipe.org/regional/asia/china/role.htm (last visited May 1, 2011).

55 Bob Tricker, *The Independent Director* in Management Accountability And Corporate Governance: Selected Readings 30 (K Midgley ed, 1982).

56 Cadbury Report (1992) ¶ 4.11

57 *Id.* at ¶ 4.12.

58 *Id.* at ¶¶ 4.13-4.14; It does not provide any cap or limit to remuneration and thus fails to delink remuneration from independence.

59 Clause 49 of the SEBI Listing Agreement which forms the basis of corporate governance in India, Listing rules of the Stock Exchange of Hong Kong Ltd. which forms the basis of corporate governance in Hong Kong is greatly influenced by Cadbury and subsequent Reports.

60 Derek Higgs, Review of the role and effectiveness of Non-Executive Directors (2003) *available at* www.dti.gov.uk/files/file23012.pdf (last visited Apr. 30, 2011).

61 *Id.* at 27.

62 *Id*.

63 *Id.* at 37.

were to be appointed by the board after recommendations from a nomination committee which would consist of a majority of NEDs.[64] It further dealt with the remuneration structure of NEDs; and recommended that the remuneration of NEDs should follow an objective and transparent standard.[65]

Some of these recommendations do find a place in the OECD Principles of Corporate Governance (2004)[66] and the UK Corporate Governance Code (2010).[67] The issue of NEDs finds a prominent mention in Indian law by virtue of Clause 49 of the SEBI Listing Agreement, which lays down mandatory corporate governance guidelines for listed companies in India.[68] These guidelines also introduce a new class of NEDs called independent directors who are at arm's length from the company.[69]

As per clause 49 (IA), the board of directors should comprise of NEDs which constitute no less than half its number. Clause 49 (IIA) stipulates that two-thirds of the members of the audit committees should be independent directors (also complemented by section 292A of the Companies Act, 1956). Annexure ID (2) (ii) of Clause 49 states that the remuneration committee should be comprised entirely of NEDs (complemented by Part II, Schedule XIII of Companies Act, 1956)[70]. Thus, at present the Anglo-American Corporate Governance model generally accepts the view that the role and duty of the non-executive director is to make sure that the board of directors exercise an objective independent judgment, nominate other board members rationally, ensure the integrity of financial reporting of the company etc.[71] thereby making sure that the executive directors and the management do not divert from the best interests of the shareholders.

B. Performance Related Pay For Executives

Performance related pay for executives is thought to be an internal incentive based control mechanism to best align the interests of the executives to the interests of the shareholders, which is understood to be to the maximization of return on the equity investment.[72] Jensen and Murphy regarded performance related pay for CEOs as a

64 *Id.* at 40-41.

65 *Id.* at 56.

66 Part One, VI(E)(1).

67 ¶ A.4.

68 SEBI, Listing Agreement (2005) Clause 49, *available at* http://www.primedirectors.com/pdf/Revised%20Clause%2049.pdf (last visited Jul. 10, 2011).

69 *Id.* at (IA)(iii).

70 Remuneration Committee means in respect of a listed company, a committee which consists of at least three non-executive independent directors including nominee directors (Inserted to Companies Act, 1956 vide Notification no. G.S.R. 70(E), Feb. 8, 2011).

71 OECD, *supra* note 66; *see* also Jillian Segal, *Corporate Governance: Substance over Form*, 25 U.N.S.W.L.J. 320 (2002).

72 Basariah Salim and Wan Nordin Wan-Hussin, *Remuneration committee, ownership structure and pay for performance:, Evidence from Malaysia* (2009) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1515166 (last visited May 1, 2011); Murali Jagannathan, Internal Control Mechanisms and Forced CEO Turnover: An Empirical Investigation PhD dissertation (1996) extract *available at* http://scholar.lib.vt.edu/theses/public/etd-183513359611541/etd.pdf.

solution to the agency problems of the corporation and believed that a 'compensation policy should be designed to give the manager incentives to select and implement actions that increase shareholder wealth.'[73]

As per Murphy the performance related pay for executives may take varied and heterogeneous forms, but is usually comprise of 'annual bonuses tied to accounting performance, stock options, long-term incentive plans (including restricted stock plans and multi-year accounting-based performance plans)' [74] and special benefits like supplemental executive retirement plans.[75] An annual executive bonus plan would consist of a set performance measures (consisting of financial performances like revenues, net income, pre-tax income, operating profits etc. and non-financial performances like customer satisfaction, operational and/or strategic objectives, plant safety etc.).[76] Based on this standard, the performance of an executive will be judged and bonus paid at the end of the financial year. Murphy notes that the common payout plan under the annual bonus model is the '80/120' plan where 'no bonus is paid unless performance exceeds 80% of the performance standard and bonuses are capped once performance exceeds 120% of the performance standard.'

Stock options allow executives of a corporation to buy shares of the company at a fixed price and on completion of certain loyalty conditions (for example if they stay with the company for a fixed period of time) or on a share value trigger (where the share price reaches a particular pre agreed value) on the happening of which the executives can exercise the option (capitalise the share).[77] Stock options therefore provide a direct link between managerial rewards and share-price appreciation.[78] Other incentive plans may comprise of long term incentive plans (payouts based on performance over a period of time usually three to five years), restricted stock (similar to stock options but the period of restriction on capitalisation is longer), retirement plans (payouts to executives on their retirement may be fixed or variable based on performance or their years of service).[79]

OECD Principles of Corporate Governance (2004) support performance related pay for executives. Under the annotations to Article VI(D)(4) in Part Two[80] it clarifies that executive and board remunerations should be aligned to the long term interests of

73 Michael C. Jensen and Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 (2) J. OF POL. ECO. 225, (1990) page 1 of preprint *available at* http://www.stockoptions.org.il/Admin/App_Upload/Performance%20Pay%20and%20T op-Management%20Incentives.pdf (last visited May 1, 2011).

74 Kevin J. Murphy, *Executive Compensation* (1998), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=163914 (last visited May 1, 2011).

75 *Id.*

76 *Id* .at 11, 12.

77 *Id.* at 16.

78 *Id.* at 17.

79 *Id.* at 23.

80 OECD PRINCIPLES OF CORPORATE GOVERNANCE (2004).

the shareholder and the company and this may be achieved by allowing key executives to hold and trade stock of the company. The UK Corporate Governance Code (2010) also strongly encourages the performance related remuneration of directors. Under section D.1 it states "[a] significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance."[81] It further lays down guidelines as to how to design performance related remuneration for executive directors.[82]

The 2009 Corporate Governance Voluntary Guidelines[83] drafted by Ministry of Corporate Affairs, Government of India explicitly espouses performance related pay for directors. They state that "The performance-related elements of remuneration should form a significant proportion of the total remuneration package of Executive Directors and should be designed to align their interests with those of shareholders and to give these Directors keen incentives to perform at the highest levels."[84] These Guidelines also state that NEDs can also be remunerated by stock options,[85] presumably to also link their interests to those of shareholders. Though Clause 49 of the SEBI Listing Agreement does not directly encourage performance linked pay, it lays down disclosure requirements which states that the "details of the fixed component and performance linked incentives, along with the performance criteria, [...] Stock options[86] etc. of director's remuneration should be included in the Annual Report." Further, the Companies Act, 1956 also complements such performance linked payment overtures by allowing for Employee Stock Option Schemes and Employee Stock Purchase Plans.[87]

Thus from an Anglo-American corporate governance perspective, performance related pay for executives are geared up to align the interests of perceived 'risk-averse self-interested' executives with those of the shareholders,[88] in order to maximise the market value of stocks.

C. Market for Corporate Control

Market for corporate control is an external control mechanism in the Anglo-American corporate governance model.[89] The term market for corporate control was

81 UK Corporate Governance Code 22 (2010).

82 *Id.* at 27.

83 Ministry of Corporate Affairs, Government of India, Corporate Governance Voluntary Guidelines (2009) *available at* http://www.ecgi.org/codes/documents/cg_voluntary_guidelines_2009_india_24dec2009_en.pdf (last visited Jul. 20, 2011).

84 *Id.* at C.1.1.iii.

85 *Id.* at C.1.2.iv.

86 SEBI, *supra* note 68.

87 Clause 5(i)(a) General Instruction for preparation of statement of profit and loss, Schedule VI, Companies Act 1956.

88 Murphy, *supra* note 73 at 26.

89 Richard S Ruback, *An Economic View of the Market for Corporate Control*, 9 Del. J. Corp. L. 613, 623 (1984); *see also* Vanessa Finch, *Company Directors: Who Cares about Skill and Care*, 55 Mod. L. Rev. 179 (1992).

first conceived in 1965 by Henry Manne.[90] This idea presupposes the 'existence of a high positive correlation between corporate managerial efficiency and the market price of shares of that company.'[91] Based on this premise Manne expounded that if a company is being mismanaged then its share prices are bound to decline in comparison to other companies in the same sector or the market as a whole. The share price thus directly reflects managerial efficiency and is a "measure of the potential capital gain inherent in the corporate stock."[92] This lower share price also facilitates efforts to take over the company, wherein the primary motivation of the purchaser is the belief that they can run the target company more efficiently and thus revitalise the company, which was hitherto poorly run.[93] Manne concludes that only market for corporate control can provide 'some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders.'[94]

OECD also subscribes to this idea of market for corporate control as a corporate governance tool to oust inefficient managers. In its online Glossary for statistical terms, OECD states that "share prices of companies publicly listed on the stock exchange are often viewed as a "barometer" indicating the extent to which the management is efficiently operating the corporation and maximizing shareholder wealth."[95] It is thus unsurprising that OECD promotes market for corporate control. In its Principles of Corporate Governance (2004), OECD urges that it is in exercise of shareholders rights that "markets for corporate control should be allowed to function in an efficient and transparent manner."[96] It advocates clear and fair rules of takeover and advises against takeover defences.[97] In the Indian context, market for corporate control was proposed in 'Desirable Corporate Governance – A Code'[98] drafted in 1998 by the Confederation of Indian Industry. This code recommended simpler takeover and merger regulations with easier

90 Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 (2) J. OF POL.L ECO. 110 (1965); *see also* Henry G. Manne, *The Higher Criticism of the Modern Corporation*, LXII COLUM. L. REV. 399 (1962); HARRY G. JOHNSON, THE CANADIAN QUANDARY (1963).

91 *Id.* at 112.

92 *Id.* at 113.

93 *Id*.

94 *Id.*

95 GLOSSARY OF INDUSTRIAL ORGANISATION ECONOMICS AND COMPETITION LAW, compiled by R. S. Khemani and D. M. Shapiro, commissioned by the Directorate for Financial, Fiscal and Enterprise Affairs, OECD, 1993 *available at* http://stats.oecd.org/glossary/detail.asp?ID=3255 (last visited May 1, 2011).

96 Article II(E) Principles of Corporate Governance (2004), 19.

97 *Id.* at 19, 36 (annotations); the extract is as follows: "1. The rules and procedures governing the acquisitionof corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class. 2. Anti-take-over devices should not be used to shield management and the board from accountability."

98 Confederation of Indian Industry, *Desirable Corporate Governance – A code* (1998), *available at* http://www.ecgi.org/codes/documents/desirable_corporate_governance240902.pdf (last visited Jul. 15, 2011).

access to funding[99] based on the rationale that market for corporate control 'imposes a credible threat on management to perform for the shareholders and enhances shareholder value in the short and medium term.'[100]

Thus, market for corporate control tries to ensure that positions of management would be secure only so long as they can maintain a high market capitalisation of the firm and thereby promote efficiency and maximise shareholder wealth.

III. Solutions Under The Stakeholder Welfare Model

There are two major justifications for stakeholder welfare oriented corporate governance: First is the reward for risk justification provided by Margaret Blair,[101] wherein she argues that the notion of shareholder oriented corporate governance, on the economic justification that shareholders incur risk and should hence be rewarded with residual profit is flawed. She states that under the doctrine of limited liability, the risk undertaken by shareholders is also limited; nevertheless, there are other categories of persons related to the company who may incur unlimited risk. She gives the example of employees who develop firm-specific skills, which are useless if they get unemployed. Similarly if a company which is a market leader fails then the market segment as a whole may lose investor confidence leading to a slowdown of growth in that sector causing a ripple effect throughout the economy. Thus, she claims that "in any given firm there are likely to be a number of parties who have made firm specific investments that are at risk in the same way equity capital is at risk. Therefore the Management should focus on maximising the total wealth-creating potential of the firm, not just on the stake held by shareholders."[102] The second justification for stakeholder welfare model is the performance argument – stake holding gives managers the freedom to incorporate ideas for the long-term growth of the company, to invest in research and development and to increase the motivation of all stakeholders etc.[103]

Therefore the aim of stakeholder oriented corporate governance would be to increase the welfare of all stakeholders of the company and the probable solution would be to ensure ways in which managers can be motivated to keep the interests of all stakeholders in mind and act under a fiduciary trusteeship model. This has been achieved in a formal manner through the dual board or co-determinism structure as in Germany where the Co-determination law (*Mitbestimmung*) stipulates that all companies with more

99 *Id.* at Recommendation 13.

100 *Id.* at 8.

101 *See* Margaret M. Blair (ed.), Wealth Creation And Wealth Sharing: A Colloquium On Corporate Governance And Investment In Human Capital (1996).

102 *Id.* at 13 as quoted in Ciaran Driver and Grahame Thompson, *Corporate Governance and Democracy: The Stakeholder Debate Revisited*', *J. of Man. and Gov.* 111-130 (2002) *available at* http://www.dcu.ie/~jacobsd/StakeholderTheory1.pdf.

103 *Id.*

than 2000 employees will have a supervisory board, which will have an equal number of representatives from shareholders and employees. This supervisory board will have the power of supervising the management, approving the balance sheets, making proposals for distribution of profit etc.[104] The same function is performed through worker councils in social market economies like in France.[105] Stakeholding can also realise in an informal manner like in Japan where the notion of trust between the employees and the management triumphs over all other considerations.[106] In addition informal recognition of employee interests have operated through life-time employment systems, hierarchical promotion structures, 'consensus' decision making within the firm, and the like.[107] Thus solutions to the problems of corporate governance under the stakeholder welfare maximisation model, attempts to include all stakeholders in the decision-making matrix of the company, in such a manner that the stakeholders can guide the company with a long-term view in mind.[108]

IV. Do the Anglo-American Shareholder Primacy Solutions Work?

We understand that the shareholder primacy based Anglo-American corporate governance model bares a marked ideological similarity to the worldwide movement for harmonisation of corporate governance structures led by the OECD, and both encouraging the adoption of NEDs, performance related pay for executives and the operation of market for corporate control. However, these solutions are at the vanguard of the clash for dominance between the shareholder primacy and the stakeholder primacy model.[109] Let us now analyse if NEDs, performance related pay for executive and MCC provide the ultimate solution to the problems of corporate governance.

A. Non Executive Directors

The use of NEDs it was believed would bring an independent supervisory mechanism inside the board. Thus, NEDs could tackle contentious issues like executive pay packages, succession plans, standards of conduct as well as verification of audit statements as well as provide non-partisan checks and balances on the management of the company.

104 J. W. Lorsch, *The Workings of Codetermination*, 4 Harv. Bus. Rev. 107-108 (1991); For major criticisms of German co-determinism *see* Jean Jacques du Plessis, Anil Hargovan and Mirko Bagaric Principles of Contemporary Corporate Governance (2d ed. 2011) 342-351.

105 *See* N. Barry Business Ethics (1998) .

106 C. E. Metcalfe, *The Stakeholder Corporation*, Business Ethics: A European Review 30-36 (1998).

107 Driver and Thompson, *supra* note 102 at 20.

108 *See* Andrew L. Friedman and Samantha Miles, Stakeholders: Theory and Practice (2006).

109 *See* generally Kellye Y. Testy, *Convergence as Movement: Toward a Counter-Hegemonic Approach to Corporate Governance*, 24 Law & Pol'y 433 (2002); Samik Chakraborty and Shaswata Dutta, *Market and the Boardroom - The Indian Experience*, 1 NUJS L. Rev. 93 (2008); Alan Dignam and Michael Galanis, *Governing the World: The Development of the OECD's Corporate Governance Principles*, 10 Eur. Bus. L Rev. 396 (1999); Arthur R. Pinto, *Globalization and the Study of Comparative Corporate Governance*, 23 Wisconsin Int'l L.J. 477 (2005); Paddy Ireland, *Shareholder Primacy and the Distribution of Wealth*, 68 Mod. L. Rev. 49 (2005).

However, reality offers a different perspective. Empirical studies in the 1990s have shown that monitoring despite the proportion of NEDs on a board and remuneration committees had limited effect on the level of top management pay.[110] Similar studies by Main and Johnston,[111] Daily,[112] Klein[113] also concluded the fact that NEDs do not affect the absolute level of CEO pay. Studies by Boyd[114], Crystal[115], Traversky and Kahneman[116] etc. have shown that there might in fact be a direct correlation between high pay for NEDs and higher pay for CEOs. Thus, the Anglo-American corporate governance logic that NEDs provide an independent review of board activities in terms of CEO pay seems to lack empirical favour.

On the other hand empirical evidence from a 2007 study conducted by Julie Froud reveals that NEDs in the FTSE 100 and the FTSE 250 are drawn from a small pool of active FTSE managers, who having retired from active business commitments held more than one NED post creating a NED hegemony.[117] Froud, does not directly answer the question as to whether recycling of past and present FTSE executives as NEDs would influence corporate behaviour. However, he does analyze a few takeover scenarios and concludes that exchange of personnel between top firms in the form of NEDs leads to greater financialisation with the attraction of lucrative roles in private equity for NEDs and EDs post-retirement.[118]

Shortcomings of the use of NEDs were fully exposed by the Satyam scandal, which shook corporate India to its core in 2009. Satyam was India's fourth largest information technology company.[119] It won many accolades for 'stellar corporate governance practices' including the Golden Peacock Global Award for Excellence in Corporate Governance in 2008 by the London based World Council for Corporate

110 M Conyon and S. Peck, *Board Control, Remuneration Committees and Top Management Compensation*, 41 (2) Acad. Of Man. J. 146 (1998)as cited in R. T. Evans and J. T. Evans, The Influence of Non-Executive Director Control and Rewards on CEO Remuneration: Australian Evidence 5 (2002), *available at* http://papers.ssrn.com/sol3 papers.cfm?abstract_id=263050& (last visited May 2, 2011).

111 B Main. and J. Johnston, *Remuneration Committees and Corporate Governance.*, 23 (91A) Acc. & Bus. Res. 351 (1993) as cited in Evans, *supra* note 110.

112 C. M Daily et al, *Compensation Committee Composition as a Determinant of CEO Compensation*, 41 (2) Acad. of Man. J. 209 (1998) as cited in Evans, *supra* note 110.

113 A Klein, *Firm Performance and Board Committee Structure* (1996) as cited in Evans *supra* note 110.

114 B.K Boyd, *Board Control and CEO Compensation*, 15 Str. Man. J. 335 (1994) as cited in Evans, *supra* note 110.

115 G Crystal, In Search Of Excess 228 (1991) as cited in Evans, *supra* note 110.

116 A Traversky and D Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 Science 453 (1981) as cited in Evans, *supra* note 110.

117 Julie Froud et al, *Everything for sale: How NEDs make a difference*, (2008) CRESC Working Paper Number: 46 *available at* http://www.cresc.ac.uk/sites/default/files/wp46.pdf (last visited May 2, 2011).

118 *Id.* 12, 20.

119 Manjeet Kripalani, *India's Madoff? Satyam Scandal Rocks Outsourcing Industry* Businessweek, Jan. 7, 2009, *available at* http://www.businessweek.com/globalbiz/content/jan2009/gb2009017_807784.htm (last visited May 2, 2011).

Governance.[120] In January 2009, the Chairman of Satyam sent an email to board members admitting that he had falsified accounts from 2002-2008 and had shown inflated profits to the tune of US$ 1.04 billion.[121] Satyam had six independent NEDs in its ten-member board of directors. The NEDs in the board comprised of luminaries from the field of business and management, Harvard Law School professor, the Dean of the Indian School of Business, the Managing Partner of IndoUS Capital-a venture capital firm in the US, the Chairman of the Naval Research Board of Defence Research and Development Organisation among others.[122] In spite of such a vast accumulation of experience, the NEDs failed to detect the fraud. Quite strikingly each of these independent NEDs was paid approximately US$ 200,000 per annum as remuneration for their service to the company.[123]

Such oversight can be attributed to the confusion in the minds of NEDs in India as regards their exact role in the company's affairs and their prospective liabilities.[124] It has been clearly laid down by the Bombay High Court in *Jagjivan Hiralal Doshi and others v. Registrar of Companies*[125] that where a liability has been fixed under the statute no distinction can be drawn on the basis of full-time or part-time performance of the duties by the Director, if such director was in charge of the day-today affairs of the company.[126] However even after the clear requirement of 'being in-charge of the day to day affairs' being laid down by the law independent directors are frequently sought to be prosecuted for criminal liability. A case in point would be the prosecution of Nimesh Kampani in relation to his services as an independent director at Nagarjuna Finance.[127] Nimesh Kampani, a respected Indian banker, served as an independent director at the board of Nagarjuna Finance from 1998 to 1999. Later in 2001-2002 Nagarjuna Finance failed to replay its creditors. The law provided for harsh punishment for the management in case

120 Harichandan Arakali, *Satyam Chairman Resigns After Falsifying Accounts*, Bloomberg Jan. 7, 2009, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ahRPVLeBamxk (last visited May 2, 2011).

121 *Available at* http://www2.accaglobal.com/pubs/economy/analysis/acca/technical_papers/tech_1a.pd (last visited May 2, 2011).

122 *Three more directors resign from Satyam board*, Indian Express, December 30, 2008 online edition *available at* http:/www.indianexpress.com/news/three-more-directors-resign-from-satyam-board/404441/2 (last visited May2, 2011).123Satyam Financial Year 2007-2008 Annual Report *available at* http://www.corpfiling.co.in/CompanyFilings/CompanyFilings.aspx?companyCode=SATCOMSE (last visited May 2, 2011).

124 Vikramaditya Khanna and Shaun J. Mathew, *The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidence,* 22 NLSI Rev. 35 (2010), *available at* http://ssrn.com/abstract=1690581 last visited Jan. 10, 2011).

125 [1989] 65 Comp Cas 553 (Bom).

126 Apart from judicial pronouncements CII Task Force on Corporate Governance chaired by former Cabinet Secretary Naresh Chandra recommended in November 2009 that NEDs should not be subject to trial for noncompliance with statutory provisions unless a prima facie case can be established demonstrating that the non-executive director was liable for the non-compliance on the part of the company, i.e., that the director had knowledge of such noncompliance on the part of the company. Khanna and Matthew, *supra* note 124 at 58.

127 *Id* at 36.

of default, and in 2008-2009 the state started prosecuting Mr. Kampani as he was on the board during the period in which the loan was taken. After a long ordeal, in which Mr. Kampani remained abroad to evade arrest and jail, a court stayed proceedings against him. Although Mr. Kampani did get relief towards the end, the blatant illegality of the proceedings against the independent director shook the confidence of NEDs in other boards across India as was well documented by Vikramaditya Khanna and Shaun J. Mathew who lamented that it led to a massive 'exodus of independent directors from the boards of Indian companies in 2009.'[128]

Various empirical studies and the evidences in form of the Satyam and Enron scandals show that NEDs do not play any path-altering role in providing solutions to any form of corporate governance problems. NEDs act more like a rubber stamp on the board of directors, who hailing from similar business backgrounds and deriving pecuniary benefits, may be wary to rock the boat in its present form, thereby tending to not help either the shareholders or the stakeholders. Given the present scenario it seems that Tim Rowland was prophetic when he cynically observed that boardrooms contained potted plants and non-executives - and in his experience potted plants were often more useful.[129]

However, with a little re-structuring, NEDs can become an important tool to uphold corporate governance standards under the stakeholder welfare model. Instead of the board of directors nominating and appointing NEDs, it is suggested that the stakeholders elect/select NEDs who would represent them in the board. Thus employees of the company may elect one amongst themselves to serve as an NED, consumer advocacy groups may propose their own NED, even market regulators may select noted academicians with a business or legal background to sit on the board as NEDs. Furthermore, keeping in mind that NEDs come from many different professions and may not be adequately adept in financial/management/strategic oversight, there should be regular training sessions for NEDs to acquaint them with the fundamentals of these areas and enable them to get a clear idea as regards their objectives and strategic goals. Although this proposed system does not guarantee assured welfare maximisation for stakeholders, it would certainly bring independent ideas to the board and better the prospects of long-term growth for the company.

B. Performance Related Pay for Executives

The use of performance related pay for executives under the 'shareholder wealth maximisation' model is premised on a two-legged fallacy – first that top executives will take decisions in the interest of the shareholder if it also serves their own personal interests and second that everyone is better off if share value is maximised.

---

128 *Id.* at 40.

129 Simon Caulkin, *Are They Just Bums on Seats?*, The Observer, January 20, 2002, *available at* http://www. guardian. co.ukbusiness/2002/jan/20/madeleinebunting.theobserver (last visited May 2, 2011).

To argue that executives would only work for benefit of others if their interest is linked to such an endeavour attributes a pessimistic conception to the motives of an executive.[130] There has been substantial academic research to find out if there exists a basis for such a conclusion, and the answer is in negative.[131] This view is aptly supported by empirical studies, which have found little correlation between pay and executive performance.[132] On the other hand, it is felt that performance linked pay for executives induces executives to influence the standard against which the performance is to be judged. Murphy suggests that 'budget-based performance standards, for example, create an incentive to "sandbag" the budget process leading to an avoidance of actions in the present year that might have an undesirable effect on next year's budget.'[133] Furthermore, the performance related pay has a perverse effect on R&D as managers try to cut costs on long-term investments if they affect the current performance outcome.[134] In addition empirical studies discredit the notion that stock options tie managers to the interests of the shareholders - options reward stock appreciation not growth in terms of dividends thus executives holding options would try to reduce dividends and favour share repurchases.[135] Since the value of options increase with stock-price volatility, executives with options have an incentive to engage in riskier investments[136] with the safety of knowing that the management can always re-price the option if the share price falls too low for the option to be exercised.[137] These empirical findings, which claim that performance related pay does not in any way, reflect on the performance of the management or the company got further credence from the accounting/financial post mortem of the Enron Scandal and the Eurotunnel mismanagement.[138] Enron's top executives indulged in insider trading when they offloaded their stock but encouraged others to keep buying thus keeping the share prices high, amassing huge private gains.[139]

130 *See* Roberts, *supra* note 40 at 1548.

131 C. Perrow, Complex organizations: A critical essay (3d ed 1986) as cited in Roberts *supra* note 37 at 1548; K. Eisenhardt, *Agency theory: An assessment and review*, 14 (1) Acad. of Man. Rev. 57 (1989) as cited in Roberts, *supra* note 40 at 1548.

132 Martin J Conyon and Dennis Leech, *Top Pay, Company Performance And Corporate Governance*, 56 (3) Ox. Bulletin Of Eco. & Stat. 229, 24 4 (1994); Gregg et al, *The Disappearing Relationship Between Directors Pay And Corporate Performance*,31 Brit. J. Of Indus. Rel. 1 as cited in Conyon *supra* note 110 at 229; Gregg et al, *Compensation Of Top Directors In UK Companies*, Harvard University mimeograph (1993) as cited in Conyon, *supra* note 110 at 229; see also Lucian Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise Of Executive Compensation (2004).

133 *See* Murphy, *supra* note 73 at 15.

134 *Id.*

135 Lambert et al, *Executive Stock Option Plans and Corporate Dividend Policy*, 24 (4) J. of Fin. and Quantitative Analysis 409 (1989) as cited in Murphy, *supra* note 73 at 19.

136 Defusco et al., *The Effect of Executive Stock Option Plans on Stockholders and Bondholders*, 45 (2) J. of Fin. 617 (1990) as cited in Murphy *supra* note 73 at 19.

137 D. Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements* 52 (2) J. of Fin. 449 (1997) as cited in Murphy, *supra* note 73 at 19.

138 Wearing, *supra* note 22 at 118.

139 Enron directors got following proceeds from their share sale in the last year of Enron Fastow (US$ 33 million), Lay (US$ 184 million), Skilling (US$ 70 million), Causey (US$ 13 million) and McMohan (US$ 2 million) Wearing, *supra* note 22 at 70.

Moreover, performance related pay for executives have greatly widened the remuneration gap between workers and top executives. In 1981, average CEO compensation, with a stock option grant of 35 percent, was forty-two times the earnings of an average factory worker. By 2001, total CEO compensation, with stock options of around 85 percent, was four hundred times the earnings of the average worker.[140]

Now let us analyse if everyone is better off if the share price is maximised. Conventional wisdom suggests that shareholders who take risk by investing in a venture must be rewarded if the enterprise succeeds.[141] However, it is not just the shareholders who undertake a risk, employees invest their human capital, creditors risk their asset, consumers commit their trust etc. Thus, the society as a whole entrusts the corporation with the responsibility to undertake a long-term sustainable approach to growth in order to justify the social, political and economic risks undertaken.[142] Increase in the market price of stock does not benefit the employees, creditors or other stakeholders. Employees (at least in the lower rungs) get paid a steady salary, creditors are repaid at a fixed invariable rate of return and consumers pay a certain sum in lieu of the product; hence none of the above transactions would change fundamentally if the share price varies.[143] However, it has been suggested that under correct conditions share prices can be linked with stakeholder welfare - stock linked employee's pension funds link employee benefits with the market price of company share,[144] secondary markets for trading of debt instruments allow creditors to reap benefits from higher equity price[145] and other societal stakeholders can also indirectly partake in the high share price pie through the continued existence of the firm.[146] However to sustain this model the growth of the share price must be steady and long term.[147] Extensive empirical studies have shown that share prices vary according to the vagaries of the market[148] and managers mostly take a short-term view of the situation to influence share prices.[149] Thus to link stakeholder fate with stock price is nothing short of a catastrophe, and this view was given further credence to, in the aftermath of the

140 Margaret M. Blair, *Shareholder Value, Corporate Governance and Corporate Performance: A Post-Enron Reassessment of the Conventional Wisdom*, *in* Corporate Governance And Capital Flows On A Global Economy 61 (Peter K. Cornelius and Bruce Kogut, eds., 2003).

141 *See generally* Gordon Smith, *The Shareholder Primacy Norm*, 23 J. Corp. L. 277 (1998); Friedman, *supra* note 31.

142 *See generally* Margaret M. Blair, *Team Production Theory and Corporate Law*, Geo. L. and Eco. Research Paper No. 281818 and Georgetown Public Law Research Paper No. 281818 (2001) *available at* http://papers.ssrn.com sol3/papers.cfm?abstract_id=281818 (last visited May 3, 2011).

143 See generally Blair, *supra* note 140.

144 Eric Zeller and Maxence Manzo, *International Employee Share Purchase Plans, Stock-Option Plans, and Free Share Plans*, Int'l Bus. L.J. 125 (2007).

145 Andrea Sironi and Giampaolo Gabbi, *Which Factors Affect Corporate Bond Pricing? Evidence from Eurobonds Primary Market Spreads*, Bocconi U, Newfin Research Center Working Paper (2002) *available at* http://papers.ssrn.com/ sol3/papers.cfm?abstract_id=308299 (last visited May 3, 2011).

146 M. C. Jensen, *Value maximisation, stakeholder theory and the corporate objective functions*, (2001) TBS Working Paper no. 01-09 as cited in Blair, *supra* note 140 at 58.

147 Blair, *supra* note 140 at 59.

148 E. F. Fama, *Efficient capital markets: A review of theory and empirical work*, 25 Jour. of Fin. 383 (1970).

149 *See* Blair, *supra* note 29.

Enron, where employees who had invested in pension plans linked to the company shares, found that after the crash their pension fund worth at least US$ 1 billion had vanished.[150] Ergo, it is disastrous to suggest that stakeholder welfare should be solely dependent on a volatile and high-risk share market.

From the analyses above we find that performance related pay for executives does not solve the agency problem under the shareholder primacy model. It fosters income inequality thus paving the way for social conflict and further fails to shore up the idea that high share prices would benefit all. Thus, the notion that performance related pay is a solution to the corporate governance problem is utterly unfounded and is potentially harmful.

C. Market for Corporate Control

MCC works on the principle that stock prices reflect the true underlying value of the company, and thus it assumes that capital markets are fully efficient wherein shareholders would vote with their feet, if they are unhappy with the management's performance. It also presupposes that the sum total of the transaction loss in a takeover or merger is less than the efficiency output of the new entity. This school of thought gains strong empirical backing from Ruback and Jensesen who observed that the 'evidence indicates that corporate takeovers generate positive gains, that target firm shareholders benefit, and that the bidding firm shareholders do not lose.'[151]

Before we try to find out if takeovers are 'efficient' let us first try to find out if stock prices are in any way connected to the true worth of the company. There is irrefutable evidence to show that stock markets go through cycles of rise and depressions and the share prices vary according to this cycle irrespective of their underlying performance.[152] Adding to this periodical change in the nature of the stock exchange, we have the behavioural pattern or herd mentality of stock buyers[153] leading to a highly volatile and inefficient capital market.[154]

A quick study[155] on the comparison of dividends declared and fluctuations of share price over a 52 week period in 5 random FTSE 100 companies shows that the

150 *Enron Timeline available at* http://news.bbc.co.uk/hi/english/static/in_depth/business/2002/enron/timeline/12c.stm (last visited May 3, 2011).

151 Richard S. Ruback and Michael C. Jensen, *The Market for Corporate Control: The Scientific Evidence*, 11 J.L OF FIN.ECO. 5, *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=244158 (last visited May 3, 2011).; *see also* Easterbrook and Fischel, *supra* note 50.

152 R SCHILLER, IRRATIONAL EXUBERANCE (2000) as cited in Blair *supra* note 140 at 59; L. A. Stout, *Are Takeover Premiums Really Premiums? Market Price Fair Value And Corporate Law*, 99 YALE L.J. 1235 (1990) as cited in Blair, *supra* note 140 at 59; L. A. Stout, *Stock Prices And Social Wealth* (2000) as cited in Blair, *supra* note 140 at 59.

153 *Id.* at 144. 'Buyers are susceptible to fads and bandwagon thinking that may allow stock prices to get badly out of line with reality before enough investors will act to sell an overpriced stock or buy an underpriced one to cause the stock to move back into line'; Blair *supra* note 140 at 59.

154 *See generally* Joseph E Stiglitz and Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECO. REV. 393 (1981)

155 *Available at* www.iii.co.uk/investment/detail?code=cotn:BSY.L&it=le; www.iii.co.uk investment detail?code=cotn:IPR.L&it=le; www.iii.co.uk/investment detail?code=cotn:LGEN.L&it=le; www.iii.co.uk/investment/

fluctuations in share prices greatly outweigh the percentage of dividend declared. This indicates a system where short term financialisation is potentially rewarded over long term growth.

These empirical evidences show that capital market may not be the best judge of the underlying value of the company but is rather a fickle and whimsical punter. Assuming, *arguendo* that the markets are perfectly efficient, let us investigate if takeovers leave all the

LSE Code	52 wk high (in £)	52 wk low (in £)	Difference 52 wk low	% change on share (%)	Div. Per
BSY	849	533.5	315.5	59.13	19.4
IPR	451.50	280.2	171.3	61.13	10.91
LGEN	124.29	72.10	52.19	72.38	1.33
SGE	305	221.9	83.1	37.45	7.8
ULVR	2009	1662	347	20.88	81.9

parties better off. A takeover bid is invariably going to raise the price of the share as the acquiring company would offer a premium over the current market price of the share,[156] however once the takeover is complete the only way to push up the share price of the company would be asset stripping,[157] layoffs,[158] reductions in wages[159] and benefits.[160] Thus in a takeover although the temporary market capitalisation increases (increasing shareholder wealth), the sum total of productive capacity decreases (leaving the stakeholders worse off).

This opens an interesting debate as to whether developing countries should adopt the shareholder primacy model with a free rein given to MCC. A developing country

detail?code=cotn:SGE.L&it=le; http://www.iii.co.uk/investment/detail?code=cotn:ULVR. L&it=le; Data correct as of May 4, 2011.

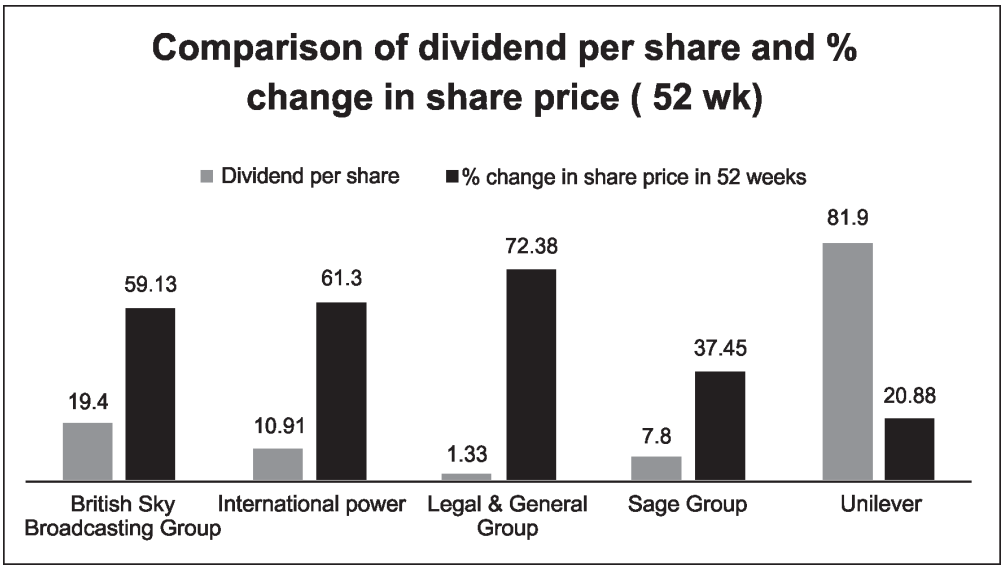
156 *See* Ruback, *supra* note 151.

157 Bhagat et al, *Hostile Takeover In The 1980s: The Return To Corporate Specialisation,* Brookings Paper On Economic Activity: Microeconomics 1 (1990).

158 A Shliefer and L H Summers, *The Breach Of Trust In Hostile Takeover*, *in* Corporate Takeovers: Causes And Consequences (A. J. Auerbach ed. 1988) as cited in Blair, *supra* note 140 at 63.

159 D Neumark, *Rents And Quasi Rents In Wage Structure: Evidence From Hostile Takeovers,* 35 Indus. Rel. 145 (1996) as cited in Blair, *supra* note 140 at 63.

160 J Pontiff et al., *Reversion Of Excess Pension Assets After Takeovers*, 21 Rand J. Of Eco. 600 (1990) as cited in Blair, *supra* note 140 at 63.



needs long term capital investments, which would build infrastructure and promote sustainable industrial growth.[161] Thus, a fast in fast out shareholder regime would rarely help in the development of emerging economies.[162] Consequently the author proposes that shares traded in markets of developing countries should have a mandatory lock in period,[163] and a shareholder who habitually abstains from voting should be penalised (for example a higher dividend tax) etc.[164]

At this juncture it is also pertinent to note that MCC forms the genesis of unregulated financial innovations which were the main cause of the Financial Crisis of 2007.[165] However, the scope of this paper does not entail a further discussion in this regard. Thus, MCC is a weak instrument as far as it attempts to solve corporate governance

161 *See generally* HA JOON CHANG, BAD SAMARITANS: RICH NATIONS, POOR POLICIES AND THE THREAT TO THE DEVELOPING WORLD (2007).

162 *See generally* Harvey, *supra* note 17.

163 Interestingly in India promoters of a company cannot sell their shares for five years after an IPO *available at* http://www.indiamarkets.com/imo/finanavenues/Tree2/html/2t6.html (last visited May 3, 2011).

164 Even more drastic measure can be taken like fixing the price of the share at the par value and let the company issue bonus shares to its shareholders along with dividend, this would eliminate speculative rise or fall of share prices however allows stable growth of shareholder wealth. If the shareholder wants to offload the shares then he would get the par value multiplied by total number of his shares (original share + bonus share) issued to him. Such an arrangement would make the shareholders look for capacity gain rather than capital gain which would lead to sustainable long term growth.

165 *See generally* TURNER REVIEW (2009) 'THE TURNER REVIEW – A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS', FINANCIAL SERVICES AUTHORITY, United Kingdom; UNITED NATIONS, 'REPORT OF THE COMMISSION OF EXPERTS OF THE PRESIDENT OF THE UNITED NATIONS GENERAL ASSEMBLY ON REFORMS OF THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM', (2009) *available at* www.un.org/ga/econcrisissummit/docs/Final Report_CoE.pdf *(*also known as the Stiglitz Report*)* (last visited May 4, 2011).

problems. Though it may lead to short spurts of capital gains through takeovers, it rarely reflects the true worth of a company and therefore can never lead to long-term growth or development.

V. Conclusion

This essay finds that the use of NEDs, performance related pay for executives and operation of market for corporate control does not solve the problems of corporate governance. Non-executive directors do not provide fail-safe neutrality or independence, performance related pay for executives do not guarantee shareholder wealth maximisation and the capital markets are never perfectly efficient as stock prices rarely show the true value of the underlying company. We find that instead of solving corporate governance problems some of these solutions further exacerbate the situation. Performance related pay for executives increase income inequality, and may even incentivise corrupt practices like insider trading, fudging of accounts. Market for corporate control similarly promotes rapid unregulated financialisation, which is believed to have caused the Financial Crisis of 2007.

Thus, there is a need to suitably amend the corporate governance mechanism to offer a strategy for long-term sustainable growth, which maximises the welfare of all stakeholders, rather than focus merely on the short-term myopic growth of share prices. This can be achieved by a simple tweaking of the existing Anglo-American corporate governance structure and orienting it towards a stakeholder welfare regime. To involve stakeholders in the decision-making process NEDs can be elected/selected by the stakeholders themselves. Thus, organisations representing consumers, employee unions, investor lobby groups, representatives of the local bodies etc. can have equal representation in the selection of NEDs. As NEDs usually undertake supervision over the executive board and form remuneration, audit committees etc.; once elected by stakeholders they would focus on long-term goals of the company rather than on short-term gains.

A criticism of NEDs under the Anglo-American system is that they do not pay much attention to their obligations and act as mere rubber stamps to the executive directors. However, once NEDs are selected by diverse interest groups they would always look after the interest of their constituents, which in most cases would mean a thrust towards long-term growth and development of the company. Another criticism of the NEDs is that they give little time to companies they look after. This is usually because under the present scenario one person can be a non-executive director in more than one company. Such a criticism can be easily addressed by stipulating by way of legislation that a person can be a non executive director in not more than one company at given point in time. Similarly, emphasis should be withdrawn from the financialisation of company and impetus should be given to increasing its productivity. This is particularly so in light of empirical studies which show that market for corporate control and

performance related pay for executives have little correlation to the absolute increase in the productive capacity of the company, though profitability of the firm may increase in the short term (which is usually achieved by retrenchment of labour, off shoring of production etc.).

Thus instead of focussing solely on market linked indicators of health of a company, efforts should be undertaken to educate the shareholders to understand the long-term indicators of growth. This would put less pressure on the management to artificially inflate the market price of shares and at the same time encourage shareholders to be long-term investors in the company. As for performance linked pay, the performance should be determined not by any absolute financial criterion but by a mixture of productivity and financial linked indexes. Furthermore, not only should the executives benefit from such a scheme but also it should be open to all the employees of the company. This would greatly help in mitigating the widening income gap between the floor shop employees and higher executives.

If these recommendations are judiciously implemented then the problems of corporate governance will be solved to a large extent and corporations will aim for long-term sustainable and inclusive growth for the welfare of all its stakeholders rather than solely focus on enriching only its shareholders.

Discussions From The Austrian School: Minimalist and Anarcho-Capitalist Approaches To And Critiques Of Public International Law

Scott James Meyer[*]

Abstract

The Austrian School of Economics as represented by such notable scholars as the Nobel Prize winner Friedrich Hayek and classical liberal scholars Frederic Bastiat, Murray Rothbard, Ludwig Von Mises and others has fostered a robust and meaningful approach to international law. The principles of the Austrian School including non-aggression, unfettered free trade, anti-collectivism, individual autonomy and many others will make for a deep and interesting critique of the current direction of international law, especially international human rights and education or "the rights of the child." This article critiques international law assumptions and theoretical positions through the lens of the works of the authors mentioned above as well as current leading scholars from the Austrian perspective. The article attempts to discover if a well-reasoned critique of international law from the Austrian perspective is compatible with a realistic and effective approach to international peace and order. Findings suggest that while significantly better than some domestic law systems, public international law currently fails to adequately provide individuals with the level of holistic protection necessary to secure for them, the libertarian ideal of individual autonomy, personal sovereignty and unfettered liberty.

I. Introduction

> *By liberty I mean the assurance that every man shall be protected in doing what he believes his duty against the influence of authority and majorities, custom and opinion.*[1]

Austrian economics, a school of thought[2] that dates back to the 15th century, has been most prominently defined, and promulgated by the works of the academics Ludwig von Mises, Murray Rothbard and Nobel Prize Laureate Frederick Hayek.[3]

The Austrian school is defined by numerous characteristics, but most notably by a devotion to the encouragement of private business in society while fiercely opposing all taxes, price controls, and other government interference and regulations that inhibit, restrict or otherwise coerce and manipulate private enterprises.[4] This makes Austrian

* LL.M. (International Law), University of Glasgow School of Law.

1 Lord Acton in his speech 'The History of Freedom in Antiquity' (February 28, 1877).

2 In order to avoid confusion, it should be said that Austrian economics does not reflect the economic situations of the nation of Austria.

3 Mises Institute, *What is Austrian Economic*? *available at* http://mises.org/etexts/austrian.asp (last visited March 23, 2011).

4 Llewellyn Rockwell Jr., Why Austrian Economics Matters? 1, 8 (1995).

Economics different from anarchism or libertarianism in its standard form because Austrians deliberately use the rules of classical liberal economics as tools to protect and expand personal liberty while curbing the influence of the state into private decisions and relationships. Llewellyn Rockwell Jr., president of the Ludwig von Mises Institute, sums up Austrian economics in this way:

> *Austrians view economics as a tool for understanding how people both cooperate and compete in the process of meeting needs, allocating resources, and discovering ways of building a prosperous social order. Austrians view entrepreneurship as a critical force in economic development, private property as essential to an efficient use of resources, and government intervention in the market process as always and everywhere destructive.*[5]

Austrian economics is an approach to the study of human action and the social world of humanity, not a set of political or other policy conclusions.[6] For the purposes of this paper, the working definition of Austrian economics is the individualist worldview of the great names of the movement including the aforementioned Ludwig von Mises, Murray Rothbard and Frederick Hayek along with other notable and important economists like Carl Menger, Henry Hazlitt, Albert Jay Nock and more. The specific notions, theories, approaches and beliefs of the Austrian school will be set out in specific detail below. Austrian economics and anarcho-capitalism (their nuances and differences to be delineated shortly) both comprise a focused and specific viewpoint for critique occupying a robust and specific position within the framework referred to as "minimalism" by Dr. John C.W. Touchie in his work "Hayek and Human Rights: Foundations for a Minimalist Approach to Law". The growth of Austrian economics into anarcho-capitalism and its value to and method of critiquing public international law, especially international human rights law and closely related issues, will be the focus of this paper.

The most prolific Austrian scholars are Ludwig von Mises, Muray Rothbard and Frederick Hayek. Some libertarians may quibble with this statement but it is my opinion that no other thinkers have contributed more to the field of free-market economic theory more than these three individuals. Their legacy is intact at such economic departments as New York University and George Mason University in the United States.[7] I will briefly discuss each of these influential thinkers and their major contributions to economic, legal and individualist theory.

---

5 *Id.*

6 Steven Horwitz, *What Austrian Economics is and What Austrian Economics is Not ?, available at* http://www.coordinationproblem.org/2010/11/what-austrian-economics-is-and-what-austrian-economics-is-not.html (last visited March 24, 2011).

7 Mark Skousen, *What are the Best Schools in Austrian Economics?, available at* http://www.thefreemanonline.org/columns/where-are-the-best-schools-in-austrian-economics/ (last visited March 23, 2011).

Ludwig von Mises fled the Nazis in 1940 and then proceeded to write his seminal work "Human Action".[8] Human Action has gone on to be arguably the most highly visible and valued work produced by an Austrian scholar. Rothbard himself said about Human Action:

> *For here was a system of economic thought that some of us had dreamed of and never thought could be attained: an economic science, whole and rational, an economics that should have been but never was. An economics provided by "Human Action". The magnitude of Mises's achievement may also be gleaned from the fact that not only was Human Action the first general treatise on economics in the Austrian tradition since World War I; it was the first such general treatise in any tradition.*[9]

Murray Rothbard capitalized on the work of Mises and produced his influential and incendiary anti-state book "Man, Economy and the State." Thus Murray Rothbard perhaps became the first major scholar who used the principles of Austrian economics to support anarchy and what came to be known as "anarcho-capitalism".[10] There will be a more developed discussion of this term below. The book "Man, Economy and the State" was instrumental in introducing a dedicated anti-state anarchist element beyond economics into the cause of the Austrian school.

Nobel Prize laureate Frederick Hayek is best known for his classic work "The Road to Serfdom." It persuasively stated that "an extensive government role in the economy inevitably means a sacrifice of personal freedoms".[11] His influence on the Austrian school was undeniably immense.[12] As I am currently living in the United Kingdom, it is worthwhile to note that the work of Hayek profoundly influenced the British Conservative party of the 1940's and Winston Churchill in particular[13], as Hayek's hatred of central planning was considered a great tool in the ideological debate against the statist central planning of National Socialism.

Austrian economics (as well as libertarianism and anarcho-capitalism in general) has been thrust further into the spotlight due to the phenomenal popularity of Texas Congressman and former United States presidential candidate Ron Paul.[14] Paul has said

---

8 Jörg Guido Hülsmann, *Ludwig von Mises: American National Biography, available at* http://mises.org/misestributes/misesjgh.asp (last visited March 23, 2011).

9 Murray Rothbard, The Essential Von Mises 36. (1st. ed., 1980).

10 Roberta Modugno Crocetta and Murray Rothbard, *Anarcho-Capitalism In The Contemporary Debate: A Critical Defense*, *available at* http://mises.org/journals/scholar/roberta.pdf (last visited March 24, 2011).

11 Greg Mankiw, *Austrian Economics, available at* http://gregmankiw.blogspot.com/2006/04/austrian-economics.html (last visited March 24, 2011).

12 Peter G. Klein, *Biography of F.A.Hayek, available at* http://mises.org/about/3234 (last visited March 24, 2011).

13 Richard Cockett, *The Road to Serfdom - Fifty Years On*, History Today 44 Issue 5, *available at* http://www.word-gems.com/wealth.hayek.50th.html.

14 Frank Newport, *Obama in Close Race Against Romney, Perry, Bachmann, Paul*, *available at* http://www.gallup.com/poll/149114/Obama-Close-Race-Against-Romney-Perry-Bachmann-Paul.aspx(utm_source =alert&utm_

openly that he entered politics because of his passion for Austrian economics [15] and his campaign rhetoric and message constantly revolved around the themes laid out by Mises, Rothbard and Hayek (indeed, he was very good friends with Rothbard for nearly 30 years). The most influential organizations promoting Austrian economics are the Ludwig von Mises Institute (with branches in the United States, Europe and Brazil), the Foundation for Economic Education and the European Center of Austrian Economics Foundation. Institutions such as the Cato Institute and the Reason Foundation are also closely aligned with the Austrian school. Austrian Economics is not simply an outdated ivory tower debate but rather a tangible and timely movement currently influencing the real world of politics and economic markets. This will be an important method of critique because the idea of the free market itself is conceptually interdependent on the notions individual self-ownership, property rights and encroaching governmental coercion.[16]

II. Why This Critique is Important to the Study of International Law

The following critique and discussion are important because the precepts of mainstream international human rights law, if worthy of being studied and discussed, will stand up to rigorous critiques of both those who claim that it does too little as well as those who accuse it of doing too much.[17] In our present situation of budget cuts and bureaucratic excesses, perhaps a minimalist critique may prove timely, relevant and helpful. One of the goals of international law is to support order in the world and the attainment of humanity's fundamental goals of advancing peace, prosperity, human rights and environmental protection.[18] I firmly believe that a rigorous and fair critique of international law through the anarcho-capitalist lens well help international law in its quest to fulfill this purpose. It is the radical and controversial nature of its power of deconstruction that so energetically yields itself to critiquing law in general and international law human rights law especially.

The question is: can the laudable goals of international law be more justly and effectively met by applying a minimalist, Austrian economic and anarcho-capitalist critique? What assumptions of international law theorists harm the cause of personal liberty? I will attempt to apply this critique by delegitimizing the mainstream assumptions of popular international human rights law theory and also in turn gain some ground for the acceptance of the Austrian viewpoint in the current international human rights law conversation. In

medium=email&utm_campaign=syndication&utm_content=morelink&utm_term=All%20Gallup%20Headlines%20-%20Politics (last visited August 22, 2011).

15 *Id.*

16 Williamson M. Evers Hobbes And Liberalism, 4,5 (1975) .

17 The use of the word "law" here meaning the discipline of studying the proper way, in theory, of how the rules of governments ought to apply to individuals living in a society.

18 Mary Ellen O'Connell, The Power and Purpose of International Law Insights from the Theory and Practice of Enforcement (1st ed. 2008); Robert Dale Owen And Frances Wright, Tracts On Republican Government And National Education 16 (1847).

order for international law to free nations and protect the rights of all the world's citizens they must first free each individual by allowing them to live in a world dictated not by the whims and desires of the state or states but by their own sense of calling, duty and preference. I hope that my paper helps in this regard.

I will be looking at the organs, stances, resolutions and majority opinions of the United Nations and the European Union international human rights law regimes, as well as other bodies where stated.[19] I will be critiquing the mainstream international public law academic establishment and engaging scholars who support these regimes where relevant and important discussion demands it and where space allows.

III. Anarcho-Capitalism

I will now define what Anarcho-Capitalism is and why it represents a worldview and legal theory consistent with and derived directly from the works of the famous Austrian scholars. In regards to minimalism and a critique of international law, anarcho-capitalism is the logical and proper extension of thought propounded by the Austrian school of economics. Though the basic concepts of anarcho-capitalism are at times unoriginal in regards to the content of the previous work and thought of the Austrians, what is distinctly and increasingly original is the manner in thinking and practice in which the original Austrian concepts are wielded and extended. Anarcho-capitalism is the practical summation of hardline Libertarianism and Austrian economics. It is important to note that anarcho-capitalists are not against rules or laws. They are against the unjust imposition of governmental pressure and coercion onto free individuals. For my purposes, it is a convergence of these anti-state traditions.

I did not start my discussion and critique with anarcho-capitalism because Austrian economics came first and it is the credible, necessary and legitimate groundwork laid by the historical and famous names of the Austrian school that helps to lend credence to the small and oftentimes demeaned, harangued and dismissed libertarian or anarchist movement within the international legal community. I am attempting to show the anarcho-capitalist movement as an internationally acceptable and functional scholarly pedigree dating back many years, astutely capturing the minds and attention of the economic arena before our current era of centrally controlled and essentially Keynesian practice of economist and governments of today.

Like any utilized popular theory, there exists many strains, traditions and opinions within that idea. In order to not get bogged down in esoteric debates about what anarcho-capitalism is, I submit the following definition and ask that any libertarian purist who might wish to debate the nuances of my definition assume that anarcho-capitalism in

19 By the terms "European Union" or "EU" the author does not mean the broader economic union of Europe but rather the human rights regime represented by such entities of the European Court of Human Rights and European Convention on Human Rights.

terms of my critique is interchangeable with anti-state minimalism, libertarianism, mini-archism (anarchy with an objective social order), private-property based individualism or any other limited-government viewpoint that is built on the tradition of the Austrian school. It is not simply any form of limited-government "constitutionalism," because as Hayek said when seeing the governments of the world expand, "our attempt to secure individual liberty by constitutions has evidently failed".[20]

Utilizing the work of Mises, Rothbard and Hayek, I define anarcho-capitalism as a philosophy that is devotedly opposed to collectivism, aggression and coercion of any kind, statism, taxes and war while dedicated to the principles of individual sovereignty, free expression, completely unrestricted free markets and voluntary interactions. In the context of international law, I define anarcho-capitalism as a philosophy that seeks to bring all international public law interactions under submission to the rules of anti-coercion and anti-collectivism in addition to upholding the rights of the individual above those of the domestic state, foreign state, union, alliance or any other organized group. As anarcho-capitalism is concerned with the sanctity of the individual, the critique will primarily be about how international legal policies, declarations and expectations affect the personal liberty of the individuals in the states rather than the states themselves. It is concerned with individual sovereignty much more than it is with national sovereignty.

Anarcho-capitalism does not at all mean that there is an absence of law or order. Quite to the contrary, I will discuss how anarcho-capitalism holds the legitimate rule of law in extremely high esteem. It does however mean an absence of state-induced coercion in any area or public or private life. The term "anarcho-capitalism" is obviously a variation of a portmanteau combining the words "anarchy" (meaning without government) and "capitalism" (meaning private markets, or for our purposes, the human action of free individuals seen both domestically and internationally). The term essentially means "human interactions without government" through truly voluntary actions.

Though anarcho-capitalism may sound radical to the uninitiated, it is actually not at all far removed from classical liberalism of 19th century Europe[21] or the constitutionalism of the American founding fathers.[22] It is not an uprising, rebellion, revolution or political platform. It is not militant nor is it antagonistic. It is never aggressive or violent. It is simply a methodology of study designed to deconstruct ideas down to a place most compatible with personal autonomy and liberty.

---

20 Friedrich A. Hayek, Law, Legislation And Liberty Volume I: Rules And Order 1 (1973).

21 Ralph Raico, *What Is Classical Liberalism?, available at* http://mises.org/daily/4596 (last visited March 24, 2011).

22 Ron Paul, *Interview with Alan Combes*, *available at* http://www.ronpaul.com/2010-05-21/ron-paul-the founding-fathers-were-libertarians/ (last visited May 1, 2011).

IV. The Unique Sources and Aims of International and Anarcho-Capitalist Law

To properly compare and contrast the sources, aims and understandings of law in both the international law and anarcho-capitalist senses, a brief discussion is in order. Once we see how each viewpoint embraces law, we will be able to more effectively critique one with the other.

A. International Law

The authority and function of law are some of the primary ideas that we will examine in discussing how each viewpoint (mainstream international law and anarcho-capitalism) understands the law to operate. Many international law scholars subscribe to the positivist philosophy of law [23]as did the majority of the international law scholars in the past.[24] According to the popular and mainstream international public law establishment, the sources of international law are generally thought to be the ones listed in the Article 38(1) of the Statute of the International Court of Justice.

International law generally refers to the duties of states towards other states. International law is not built on the obligations of individuals but on the obligations, duties and actions of states and according to Professor Eric Posner it could be no other way. If it were not so, he states that:

> *It becomes vulnerable to the births and deaths of individuals, migrations, the dissolution and redefinition of groups, and ambiguity about the representativeness of political institutions. States would flicker, and so would their obligations to treaties and rules of customary international law.*[25]

When the anarco-capitalist becomes concerned is when a state promises another state or group of states to coerce or otherwise rule over its domestic citizens in way incompatible with the Austrian conception of individual liberty and autonomy. When a domestic state takes on any legal obligation other than that of maintaining liberty for its citizens, and international law supports, enables or encourages this step, that is when international law becomes as bad to the anarcho-capitalist as the domestic laws that they so frequently protest against.

The aim of international law is to monitor the behavior and interactions between states, maintaining and providing essential law and order by way of the United Nations and other overseeing bodies.[26] The United Nations is an international organization

23 Jörg Kammerhofer & Jean d'Aspremont, Mapping 21st Century International Legal Positivism in International Legal Positivism in a Post-Modern World 1 (2010).

24 Stephen Hall, *The Persistent Spectre: Natural Law, International Order and the Limits of Legal Positivism,* 12 Eur. J. Int'l L. 271 (2001).

25 Eric Posner, *Do States Have a Moral Obligation to Comply with International Law?*, 55 Stan. L. Rev.1905 (2003).

26 Aron Mifsud-Bonnici, *The Aim of Public International Law, available at* www.mifsudbonnici.com (last visited March 28, 2011).

committed to maintaining peace and security, developing friendly relations among nations and promoting social progress, better living standards and human rights for all.[27] Within states that are members of the United Nations and other regional state associations (the European Union, which will be another example critiqued in this paper) these states have obligations to their own citizens and citizens of other member states in accordance with certain treaties and charters. There are select courts and tribunals set up to help states fulfill these aims.

One of these that I will be critiquing later in the paper is the European Court of Human Rights.[28] The aim of the European Court of Human Rights is to improve the capacity of national courts and law enforcement authorities to apply legal human rights protections.[29] The ECoHR is a type of "constitutional court" in part because of its identity as an institution designed to protect and recognize those rights that belong to the citizens of member States regardless of and often in the face of changing governments and political opinions.[30]

International law has unique functions beyond global and international interactions. It has the ability to influence the moral attitudes, choices, and behaviors of individuals and states so much so that it is impossible to deal with international law apart from international ethics and morality.[31] Professor Yasuaki also points out the memorable claim of Professor John Austin that international law is not law in a proper sense but a term of positive morality.[32] It is this connection between international law and moral choices that influences the worldview of each global citizen that is of particular interest and concern to the anarcho-capitalist school.

B. Law in the Anarcho-Capitalist Tradition

The net effect of law in anarcho-capitalism is legitimate only to the extent that it frees each individual by allowing them to live in a world dictated not by the whims and desires of the state or states but by their own sense of calling, duty and preference. This often means that an absence of positive law is preferable in a great many areas of private and public interactions, ideally with courts being replaced with private procedural bodies and even replacing the police with private security agencies.[33] The law is an individual

27 Scott Meyer, *United Nations Law Summative Essay, The United Nations General Assembly* 1 University of Glasgow (2011) *citing* http://www.un.org/en/aboutun/index.shtml

28 Hereinafter ECoHR.

29 The European Union Agency for Fundamental Rights, 2010.

30 *Supra* note 27.

31 Onuma Yasuaki, *International Law in and with International Politics: The Functions of International Law in International Society*, 4 Eur. J. Int'l L 106 (2003).

32 John Austin, The Power Of Jurisprudence Determined 127, 140, 142 (Wiedenfeld and Nicholson, eds,. 1954).

33 Hans-Hermann Hoppe, *Mises Institute, The Idea of a Private Law Society*, *available at* http://mises.org/daily/2265 (last visited March 27, 2011).

experience and process that becomes invalidated any time a group attempts to give itself rights different from the individual. In anarcho-capitalism the law should act as part of a social order or mechanism. It should be a buttress in upholding the rights of the individual above those of the domestic state, foreign state, union, alliance or any other organized group. Anarcho-capitalists have traditionally been very wary and pessimistic but not necessarily hostile towards international law. Discussing the ability of international law to provide lasting peace in the world, Ludwig von Mises in his iconic work Human Action said:

> *It is futile to place confidence in treaties, conferences, and such bureaucratic outfits as the League of Nations and the United Nations. Plenipotentiaries, office clerks and experts make a poor show in fighting ideologies. The spirit of conquest cannot be smothered by red tape. What is needed is a radical change in ideologies and economic policies* [34]

In stark contrast to legal positivism, anarcho-capitalist scholars hold to a variety of legal philosophies, all of which oppose state, organizational, court and judge-made law. Murray Rothbard, widely considered the "dean of the Austrian school"[35] and his followers hold to a non-religious and what he called "rationally established" interpretation of natural law.[36] To Rothbard the law is simply a set of commands[37] which should be based around a set of objective ethics that can be established through reason.[38] This definition is of course contested by HLA Hart who would view the law not simply as rules but as processes or a discipline, as laid out in his seminal work "The Concept of Law."

The definition of natural law is not overly technical and according to Rothbard is best laid out by Sir William Blackstone in book one of his commentaries on the law of England:

> *This is the foundation of what we call ethics, or natural law. For the several articles into which it is branched in our systems, amount to no more than demonstrating, that this or that action tends to man's real happiness, and therefore very justly concluding that the performance of it is a part of the law of nature; or, on the other hand, that this or that action is destructive of man's real happiness, and therefore that the law of nature forbids it.*

Rothbard elaborates:

> *The natural law, then, elucidates what is best for man what ends man should pursue that are most harmonious with, and best tend to fulfill, his nature. In a significant sense, then, natural law provides man with a "science of happiness," with the paths, which will lead to his real happiness.*[39]

34 Ludwig Von Mises, Human Action 821 (Reprint ed. 1966).
35 *See* http://www.lewrockwell.com/rothbard/rothbard-lib.html.
36 Murray Rothbard, *Law, Property Rights and Air Pollution*. 2 Cato Journal 55(1982).
37 *Id*.
38 *Supra* note 36.
39 *Id* at 12.

As to what this valued and sought-after "happiness" is, Rothbard and Blackstone would of course greatly disagree. To Rothbard, happiness is best achieved when an individual is entirely at liberty, because it is only this liberty that allows the individual to deeply and truly appreciate and enjoy all possible domains of life.[40] International law then is only ethical, right or legal when it makes individuals and nations (in that order) more at liberty. In stark contrast to the mainstream approach to international law, this is the thrust of the anarcho-capitalist approach to international law.

Ludwig von Mises disagreed with the natural law theory and held to the legal philosophy of utilitarianism.[41] Relying on the views of political philosopher Jeremy Bentham, Mises believed that the law should be "intent upon discovering what best serves the promotion of human welfare and happiness".[42] He believed that legal positivism was a futile approach to law and declared that "what counts is not the letter of the law but the substantive content of the legal norm".[43] He believed that the rule of legitimate law must be obeyed since the only other option is the rule of the state.[44] Mises was a notorious critic of the United Nations and when considering the confusion of implementation and enforcement of international law he said that any attempt to create a substantive international law whose application is disputed among nations can be declared to have been miscarried.[45] UN norms fail to promote human welfare and happiness because they are based primarily on the faulty reasoning of state coercion and collectivist reasoning (among other faulty statist mantras).

Mises stands firmly in the anarcho-capitalist camp when discussing the issue of coercion. Speaking of the ability of nations to assert their version of the law on their citizens Mises says:

> *The state is a human institution, not a superhuman being. He who says state means coercion and compulsion. He who says: There should be a law concerning this matter, means: The armed men of the government should force people to do what they do not want to do, or not to do what they like. He who says: This law should be better enforced, means: the police should force people to obey this law. He who says: The state is God, deifies arms and prisons.*[46]

40 Anthony Flood, *Murray Rothbard: An Introduction to His Thought, available at* http://www.anthonyflood.com murrayrothbardthought.htm.

41 Murray Rothbard, *Ludwig von Mises and Natural Law: A Comment on Professor Gonce,* IV, 3 J. Libenman Stud. 289 (1980).

42 *Supra* note 34.

43 Ludwig Von Mises, Nation, State, And Economy 173 (Reprint ed. 1983).

44 Ludwig Von Mises, Bureaucracy 76 (1944).

45 *Supra* note 43 at 90.

46 Ludwig von Mises, Omnipotent Government 47 (1944).

For Mises, the law should work in a non-compulsory and useful way, it should be a tool of societal protection of the individual against the state and any international agreement, alliance, treaty, directive or other international legal commitment.

Other Austrians held similar or nuanced views of the anarcho-capitalist vision of the law. Frederick Hayek believed that liberty could be greatly served under the rule of law, contending that justice and general welfare are the convergent goals and values of law. Hoppe stated that "It is the purpose of laws or norms to help avoid otherwise unavoidable conflict" and that the state is a poor arbiter of legal disputes as it is not a disinterested party.[47] Private property protection being a hallmark of the anarcho-capitalist philosophy, it is worth noting that anarcho-capitalists see the law as something that exists in the first instance to help protect personal property. This primary function of law precedes any other discussion on the purpose and usefulness of law. French scholar and libertarian hero Frederich Bastiat said: "Life, liberty, and property do not exist because men have made laws. On the contrary, it was the fact that life, liberty, and property existed beforehand that caused men to make laws in the first place".[48]

This line of reasoning can be contrasted to Thomas Hobbes and his opinion that the tendency of people to naturally act badly justified laws laid down by the state, so that rights are traded for guidelines on living in the form of a "social contract"[49] Hobbes believed that:

> *The liberty that each man hath, use his own power, as he will himself, for the preservation of his own nature; that is to say, of his own life; and consequently, of doing anything, which in his own judgment, and reason, he shall conceive to be the aptest means thereunto.*[50]

For Bastiat and the anarcho-capitalists, actual individual choices and relationships always trump what they would no doubt consider a sham philosophical "contract" regardless of one's perceived inclinations of mankind. Hobbes is generally considered by anarcho-capitalists to be a totalitarian and an enemy of property rights.[51]

Legal scholar Robert Hale contributed another view of property rights, naming the government as the coercive arm of the property owner against those who unfortunately may not necessarily have any property to protect:

> *In protecting property, the government is doing something quite apart from merely keeping the peace. It is exerting coercion wherever that is necessary to protect each owner, not*

47 Hans-Hermann Hoppe, *The Idea of a Private Law Society, available at* http://mises.org/daily/2265 (last visited March 27, 2011).

48 Frederic Bastiat, The Law (2d ed. 1998).

49 Mika La Vaque Manty, The Playing Fields Of Eton Equality And Excellence In Modern Meritocracy 76(2010).

50 Thomas Hobbes, The Leviathan 79(1st ed. 1651), *available at* http://socserv.mcmaster.ca/econ/ugcm/3ll3/hobbes/Leviathan.pdf

51 Williamson M. Evers, Hobbes And Liberalism 4,5 (1st ed. 1975); *Supra* note 36.

merely from violence, but also from peaceful infringement of his sole right to enjoy the thing owned.[52]

This reliance on the state in this instance may seem hypocritical to those libertarians (such as Congressman Ron Paul) who believe that the state (in his case, the United States government) has a constitutional duty to protect private property. In a free market, Hale would seem to demand more fair access to or protection from the means of coercion regardless of the property in question. The Austrians would say that coercion is always violence, taxes are always theft and that voluntary private choices will always provide a better framework in which to pursue societal goals.

C. The Anarcho-Capitalist and International Law: Obvious Tension with Potential Agreement and Cooperation

Ironically, what are considered disparaging and frustrating problems in international law are what would most attract anarcho-capitalists to its cause. The apparent absence of an enforcement mechanism in international law would be seen as a virtue by anarcho-capitalists. One of the basic tenets of the anarcho-capitalist philosophy is non-coercion in life and law. The lack of a "sword"[53] is to the anarcho-capitalist a beautiful thing. Though anarcho-libertarian scholars are hesitant to accept the premises and obligations of much of international law, they have found it useful when opposing the domestic policies of their home countries. Congressman Ron Paul was vocal and steadfast that the invasions of Afghanistan and Iraq were both immoral and illegal according to international law[54], as well as critiquing the United Nations when it provides impetus for intervention and invasions by such things as the "responsibility to protect".[55]

One of the most popular topics that generally uninformed Americans complain about is that embracing international law and the United Nations represent a threat to the national sovereignty of the country. Even if this were to be true, to the anarcho-capitalist this could be in fact a very good thing. If the sovereignty of a nation correlates with the sovereignty of the individual such as that when the sovereignty of the nation decreases the sovereignty of the individual increases, then to the extent that international law through treaties, agreements and other expectations actually increases personal sovereignty by draining power away from the state, this is to be applauded and encouraged. Rothbard described those who were hung up on the international independence of America as "reactionaries and jingoists, emotionally and irrationally devoted to the mystique of

52 Robert L. Hale, *Coercion and Distribution in a Supposedly Non-Coercive State,* 38 Political Science Quarterly 470-478 (1923).

53 James G. Apple, *Enforcement Of International Law Is Not Dependent On A "Sword" Or Enforcement Mechanism, available at* www.judicialmonitor.org/archive_0207/generalprinciples.html.

54 Ron Paul, Fox News Republican Presidential Candidates Debate Presented in Durham, NH., USA, (September 2007).

55 *Id.*

American 'sovereignty' ".[56] So, the age-old "national sovereignty" complaint falls by the wayside.

In discussing the understanding of law in the anarcho-capitalist tradition, it becomes clear that though they are unyielding in their enshrinement of personal liberty above all else, there is room to obey and appreciate some form of international law as in theory international law could mean that some subject matter would be outside of the jurisdiction of a coercive domestic state and centralized legal system. While the Austrian scholars have their doubts and reservations about the overriding concept of entities such as the United Nations and the European Union, the actual legislation and practice of international law is at times more favorable in their approach than are most domestic legal structures. There is enough admiration of some of the elements of international law by anarcho-capitalism that a well-reasoned critique is possible. I will now discuss two subjects that have been focused on by international law in various degrees by international legislation, scholarship, UN declarations and popular interest. These topics are international human rights and "the rights of the child" with respect to education.

V. HUMAN RIGHTS

Anarcho-capitalists are certainly not the only group that questions the current international human rights law regime, which is seen by many to be both excessively rigid and unnecessarily vague,[57] but their tradition promises a uniquely lively and energetic discourse on the subject. Through both treaty and charter-based systems, the international community has placed human rights expectations and obligations on states via international law. One of the primary statements on Human Rights within international law is the Universal Declaration of Human Rights[58] adopted by the UN on December 10, 1948. The General Assembly called upon all member states "to cause it to be disseminated, displayed, read and expounded principally in schools and other educational institutions, without distinction based on the political status of countries or territories"[59]. Many rights are listed in the UDHR including the right to equality, freedom from discrimination, marriage and family, a fair trial and others. The rights contained in the declaration represent the minimum standard of human rights due to each person's status as a human being rather than as a citizen on any one nation. Diana Ayton-Shenker puts it this way:

> *Universal human rights do not impose one cultural standard, rather one legal standard of minimum protection necessary for human dignity. As a legal standard adopted through the United Nations, universal human rights represent the hard won consensus of the*

56 MURRAY ROTHBARD, THE TREATY THAT WALL STREET WROTE (Reprint ed. 1995), *available at* http://mises.org/daily/4493 (last visited March 29, 2011).

57 Eric Posner, Human *Welfare, Not Human Rights*, 108 COLUM L. REV. 1763 (2008).

58 Hereinafter UDHR.

59 Universal Declaration of Human Rights, Dec 10, 1948, 217 A (III), *available at* http://www.un.org/en/documents/udhr/index.shtml.

> *international community, not the cultural imperialism of any particular region or set of traditions. Like most areas of international law, universal human rights are a modern achievement, new to all cultures. Human rights are neither representative of, nor oriented towards, one culture to the exclusion of others. Universal human rights reflect the dynamic, coordinated efforts of the international community to achieve and advance a common standard and international system of law to protect human dignity.*[60]

International law protects human rights in two primary ways: by joining treaties obligating states to ensure human rights protections and also by the providing for mechanisms such as the United Nations Human Rights Council and the European Court of Human Rights to help see to it that international human rights are being practiced at the local level (United Nations Human Rights Regional Office for Europe, 2010). These bodies (especially the ECoHR) have interpreted existing human rights law, scholarship and judicial activism as a means of greatly expanding the protections of human rights in the daily life of Europeans.

This begs the questions of how does international law classify something as a right and on what legal basis is it sought to be protected? Having figured that out, how does anarcho-capitalism define and protect human rights? Space will not allow for a detailed critique of each of the rights provided for in the UDHR and the decisions of the ECoHR but I will instead look at the theoretical underpinnings of each system of thought. There are a great many opinions, theories and perspectives in regards to international human rights law and it is not important that anarcho-capitalism critique each of them. The one thing that the majority of the perspectives of mainstream international human rights law theorists and academics have in common is the positive obligations of the state to secure human rights for people and the general concept that the majority of human rights obligations are of the "positive" rather than the "negative" variety.

To believe in positive rights is to believe that a person has a right to a certain benefit in the sense that this right must or should be proactively provided, maintained and protected. This perspective is completely discarded by the anarcho-capitalist school who believe that rights exists primarily in the negative sense. To use a popular example, a "right to food" is not a right for food to be provided to you at someone else's expense, but rather the right for you to be able to eat food that you've provided for yourself without being harassed or hindered. There would also be no positive "right to health care" provided by others, only the right to not be molested in your personal pursuit to procure health care in the event that you are inclined and able to do so.

The theory of negative rights has been used publicly of late by the Libertarian (though Republican in official designation) United States Senator from Kentucky, Doctor Rand Paul (the son of Ron Paul) in an attempt to scale back the encroaching specter of

60 Diane Ayton Shenker, The Challenge of Human Rights and Cultural Diversity (1995).

a positive right to healthcare in the United States. In a statement during a Senate subcommittee hearing he likened the conscription of healthcare professionals into an obligatory relationship with people as that of forced slavery, as a right presupposes a resort to force in order to see that right positively enforced. Speaking of the American tradition of negative rights, he said that "Our founding documents were very clear about this. You have a right to pursue happiness; but there's no guarantee of physical comfort, there's no guarantee of concrete items".[61]

Rothbard regarded all rights as fundamentally negative rights. In his classic work, "The Ethics of Liberty"[62] Murray Rothbard agrees with James Sadwosky who has this to say about positive and negative human rights obligations:

> *When we say that one has the right to do certain things we mean this and only this, that it would be immoral for another, alone or in combination, to stop him from doing this by the use of physical force or the threat thereof. We do not mean that any use a man makes of his property within the limits set forth is necessarily a moral use.*[63]

Hayek was also devoutly opposed to positive human rights obligations because he felt that they were too vague to be properly enforced by a rational classically liberal functioning rule of law.[64] He has admitted a desire to see the needs of people met but cannot acquiesce to the government fulfilling positively these needs because of the failure of democracy to properly limit the scope, depth and expansion of government power in these areas.[65] In our current actual international legal climate where positive human rights obligations are so frequently disregarded, a vibrant and committed human rights policy based on negative rights might be more practical and easily applicable, as states tend to take negative rights more seriously than the positive rights.[66]

Anarcho-capitalists agree with international human rights scholars that rights do belong intrinsically to people whether or not a government recognizes them. They agree firmly with international human rights proponents in saying that rights do not originate with the state and come from either nature, God, tradition, rationality or human necessity. However, with the exceptions of such human rights issues as the right to a fair trial or the right to not be held without cause, which anarcho-capitalists would consider as more concrete domestic criminal law procedural issues rather than internationally-enforced human rights standards; anarcho-capitalist thought refuses to acknowledge that any state

61 Rand Paul, Speech text and Video from DailyMail.co.uk, *available at* http://www.dailymail.co.uk/news/article-1386658/Rand-Paul-says-having-right-health-care-like-believing-slavery.html#ixzz1MH4bXyO8 (last visited May 13, 2011).

62 *Supra* note 36 at 24.

63 James A. Sadowsky Private Property And Collective Ownership 120, 121 (1974).

64 John C. W. Touchie, Hayek And Human Rights: Foundations For A Minimalist Approach To Law 12 (1st ed. 2005).

65 *Id.* at 174.

66 *Supra* note 57.

or collectivist body has the authority to burden people and institutions with positive duties in regards to human rights. Anarcho-capitalists despise coercion in all its forms. Anarcho-capitalists are much more concerned about such things as abuses by police officers than they would be with a "right to housing" paid for by either taxing a portion of the population or paying for it with inflationary fiat currency that harms future generations of working producers.

When the UDHR claims that humans have a right to food (food that most likely has been produced and paid for by the tax dollars which were the former private property of another human appropriated by force by a government), anarcho-capitalists will agree that nobody has a right to prevent them from farming, taking a job in a free market to earn money for food (or indeed to be paid in food). Rothbard, Hayek, Mises and their followers see no legitimate moral or legal duty for one person to provide a benefit to another and any attempt of a government to use their monopoly on force to do so is acting immorally and illegitimately. Another way to put it is to say that anarcho-capitalists believe in every human right possible as long as it does not have to be paid for by anyone else and is not a positive obligation of the state or anyone else. Anarcho-capitalists reject the international human rights law vision because it is an abridgment of personal property rights through imposing taxes and limitations on individuals and because it violates the free conscious of humans by imposing on them via an international organization of some type a positive duty of which they never consented.

Anarcho-capitalists have long come to terms with the notion that life is not fair. According to them, this fact can be attributed partly to government intervention into private markets and private life as well as hazardous international policies creating entanglements not beneficial to the common citizen.[67] The anarcho-capitalist would never seek to propound these inequities by the irrational notion of further distributing wealth and capital by way of unfairly taking the fruits of someone else's labor to provide a "right" to another.

VI. Collectivism in Human Rights Law

The United Nations and other international institutions believe that some rights are sometimes best provided and protected for when granted collectively to groups. This is seen in Article 29 of the UDHR states that "Everyone has duties to the community in which alone the free and full development of his personality is possible" and Article 4 Part 2 of the UN International Covenant on Economic, Social and Cultural Rights which states that:

> *The States Parties to the present Covenant recognize that, in the enjoyment of those rights provided by the State in conformity with the present Covenant, the State may subject such rights only to such limitations as are determined by law only in so far as this*

67 Murray Rothbard, What Has Government Done To Our Money? 56 (5th ed. 2005).

> *may be compatible with the nature of these rights and solely for the purpose of promoting the general welfare in a democratic society.*

The idea that rights proceed from the government and exist to protect the community as a whole, to be limited as the government sees fit for the betterment of the community (logically assumed at the cost of at least some individuals) is the current practice of the UN and is appreciated by many international human rights scholars. International human rights law scholars believe that collectivism (or "group rights") as being simply the sum total of the rights of the individual members in a certain group and that individuals can assert both an individual and collective right in an effort to achieve maximum human rights protections.[68]

Anarcho-capitalists oppose collectivism in all its forms, as they see it as a catalyst for such despised ideas as racism, socialism, the welfare state and anti-free market "class warfare" rhetoric. Even such common rights intrinsically belonging to a group of more than one person, such as a community right to water, are conceptually rejected by anarcho-capitalists. They agree with the classically liberal understanding of rights being an individualized concept rather than as something tangibly given to a group of individuals. Anarcho-capitalists oppose the collectivist understanding of human rights because it requires the strong arm of a coercive government to sanction collective group identities and protect them on the basis of numbers against individuals who have not been given the same class status by the state. They believe that bonafide human rights exist because the person seeking their protection is a human rather than as a special class of human or politically favored citizenry. Anarcho-capitalists consider it an anathema to have certain individuals separated into a more (or less) protected class and given an oftentimes politically correct and expedient labeling based on group membership.

The Austrian tradition teaches that all of society is comprised of (or at least should ideally be comprised of) individuals making completely free choices apart from coercion or governmental interventions. Collectivist human rights theories fly in the face of such dogma when they seek to put certain individuals into privileged or hampered groups. Because collectivism seeks the group over or against individuals, it ultimately fails to truly protect the rights of anyone. One libertarian has put it this way:

> *Collectivism replaces voluntary and mutual cooperation with physical force as the essence of human interaction. Individuals are regarded as sacrificial appendages of an abstract group, to be commanded as chattel. The judgment of bureaucrats replaces the judgment of individuals motivated to pursue their own values and thus, individuals are not able to make rational and logical decisions nor are they allowed to cooperate voluntarily and mutually with others. The lack of productivity and stagnation follows.*

68 Douglas Sanders, *Collective Rights*, 13 HUM. RTS. Q. No.3 368, 386 (1991).

Mises himself believed that it is only through uncompromising individualism that the rights of collective groups would be protected. In "Human Action" he writes "In striving after his own-rightly understood-interests the individual works toward an intensification of social cooperation and peaceful intercourse."[69]

Of course, anarcho-capitalists desire to see humankind live in harmony without any fundamental rights violated. However, in their struggle against the state, they are on guard against the term "human rights" becoming essentially the catchword used by those who promote government interventions and expansion into often private situations in the name of securing a better life for some while using other people's resources to accomplish that goal. All in all, the international law vision for human rights unfortunately fails when critiqued by the anarcho-capitalist framework because it is statist, expansionist, representative of the abridging and disregarding of personal property rights and insistent on positive and often collective human rights obligations.

VII. Education and "The Rights of the Child"

Since the family is the primary building block of society, it is only fitting that the Austrians have a distinct outlook regarding the raising of children. Universal compulsory education is a primary concern for the United Nations and this is reflected in a myriad of conferences, goals, declarations and committees dedicated to the cause of education worldwide. The UN has made it one of its 2015 Millennium Goals that by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.[70]

The European Union has also seriously committed itself to the furthering of education within EU states by adopting numerous educational policies and initiatives. Article 165 of the Treaty on the Functioning of the European Union says that the EU must "contribute to the development of quality education by encouraging cooperation between Member States." These educational goals are to be met by states and state governments, preferably by a free state-funded and operated public school system (though states are encouraged to make use of private schooling institutions as long as they are meeting the standards of the UN and EU).

Education is considered a right by the UN and it is guaranteed by Article 26 of the UDHR which reads that:

> *(1) Everyone has the right to education. Education shall be free, at least in the elementary and fundamental stages. Elementary education shall be compulsory. Technical and professional*

69 *Supra* note 33.

70 Statement By Kishore Singh, Special Rapporteur On The Right To Education, 65th Session Of The General Assembly Third Committee Item 68 (B) 25 New York October 2010, *available at* http://www.ohchr.org/Documents/Issues/Education/SREducationStatement2025102010.

education shall be made generally available and higher education shall be equally accessible to all based on merit.

(2) Education shall be directed to the full development of the human personality and to the strengthening of respect for human rights and fundamental freedoms. It shall promote understanding, tolerance and friendship among all nations, racial or religious groups, and shall further the activities of the United Nations for the maintenance of peace.

(3) Parents have a prior right to choose the kind of education that shall be given to their children.

We will soon see the tension between number three in the list above and the actual practice of international law when it comes to the protections of families who choose to home school their children, as many anarcho-capitalists do and as every anarcho-capitalist believes families ought to be able to do.

What goes on inside schools is a concern of the UN. UN Special Rapporteur Kishore Singh has said that:

In this sense, we must continuously verify if human rights are respected inside the gates of our schools today. Thus, I will pay particular attention to the standards and mechanisms that ensure all educational entities comply with the standards provided by human rights law.

This sort of involvement in education by the international law community is seen by anarcho-capitalist as being far outside their sphere of jurisdiction and represents a potential tyrannical imposition of a value system at odds with their own onto their children that belong only to them and not a community, global village or to the world.

In addition to listing education as a fundamental human right due to children, the international legal community has also listed other rights and has made other efforts to secure human rights to children as a group. The UN Convention on the Rights of the Child[71] is a prolific declaration concerning the rights due children and is monitored by the UN Committee on the Rights of the Child. The rights of the child include the right to life, to be raised by their own parents, to express their own opinions, privacy, to not be exploited, legal representation, health care, enjoyment of their culture, to not be forced into armed conflicts, protection against corporal punishment and the death penalty and that decisions of states be made in the best interest of the child).[72] The United States has signed but not ratified the Convention on the Rights of the Child. The EU has similar protections in place with the duty of enforcing these rights of children against states and even their own parents sometimes falling to the European Court of Human Rights.

71 Hereinafter CRC.

72 Jodie Martin, *Guide to Children's Rights* (2008), *available at* http://www.suite101.com/content/childrens-rights-are-important-a44482 (last visited April 14, 2011).

There is a distinct Anarcho-Capitalist vision for children's rights and education:

> *It is better to tolerate the rare instance of a parent refusing to let his child be educated, than to shock the common feelings and ideas by the forcible transportation and education of the infant against the will of the father.*[73]

Compulsory public schooling is the law in the United States, though each individual state currently has some form of legislation allowing for private schools and homeschooling of children. If there is one topic which you can count on all anarcho-capitalists agreeing on, along with the abolishment of the income tax and the Federal Reserve bank in the United States, it is that homeschooling is a sacrosanct human right and that governments have no right, duty or acumen in properly educating children. If there are any exceptions to this rule in anarcho-capitalist circles, I am unaware of them. As discussed previously, they would also balk at extending any special human rights protections solely on the basis of an individual belonging to a specific group (in this case, an age group). Due to the anarcho-capitalist insistence on negative rights and anti-collectivism, the majority of specific international law provisions for children would not be recognized by anarcho-capitalists. They would instead be seen as governmental intrusion into and usurpation of the last bastion of sovereignty apart from the state, which is the family. The church is seen in similar fashion, with sometimes overlapping jurisdiction in the realm of education. I will now lay out the anarcho-capitalist conception of the "right" to public education versus the practice of homeschooling, un-schooling or no-schooling.

The anarcho-capitalist leaders of the past were fundamentally opposed to state funded public education and were in favor of rights and protections for homeschooling families. In his book "Liberalism," Mises said:

> *There is, in fact, only one solution: the state, the government, the laws must not in any way concern themselves with schooling or education. Public funds must not be used for such purposes. The rearing and instruction of youth must be left entirely to parents and to private associations and institutions.*[74]

Reflecting on the Prussian model of education influencing the American public educational system, Mises commented that "continued adherence to a policy of compulsory education is utterly incompatible with efforts to establish lasting peace".[75] Hayek never formally commented on homeschooling or public education, but his dedication to curbing the centralized power of government in public and private life would suggest that today he would be firmly in the anti-public school movement of anarcho-capitalism.

---

73 Thomas Jefferson: *Note to Elementary School Act*, 1817. ME 17:423.

74 Ludwig Von Mises, Liberalism 114 (Irvington ed., 1985).

75 *Id.*

Murray Rothbard was unrelenting in his criticism of state involvement in education and sought the abolishment of public schools and the United States Department of Education. He argued that public education did not actually seek to educate children at all but rather to indoctrinate and propagandize children into the service of the state, and that truancy and compulsory attendance laws represented the "complete seizure and incarceration" of young people.[76] The state is not shy in describing their goals in education. Rothbard cites early public education campaigners Frances Wright and Robert Dale Owen in their own words: "It is national, rational, republican education; free for all at the expense of all; conducted under the guardianship of the State, and for the honor, the happiness, the virtue, the salvation of the state".[77]

The anti-state view towards education held to by Mises and Rothbard were fundamental in setting up the anarcho-capitalist worldview. Political sensation Ron Paul campaigned on the promise of shutting down much of the United States bureaucratic agencies with the Department of Education to be one of the very first to go. Paul has spoken frequently on homeschooling, maintaining that home education represents the most powerful step in preventing the state from indoctrinating by propaganda a new generation of students.[78] For the anarcho-capitalist the collective, compulsory and statist model of public education is completely incompatible with a free society and any legal attempt by the UN and EU to encourage and implement such a regime sets a terrible standard and example for states attempting to find their own way to educate their young people.

Homeschooling is often correctly associated with right-wing religious devotees. Mises and Rothbard were both atheists in religious identity and Jewish by birth, yet they defended homeschooling with a passionate vigor. Indeed the majority of homeschoolers are devoutly religious, clinging to the Biblical verses in Deuteronomy 6:5-9 which says:

> *You shall love the Lord your God with all your heart and with all your soul and with all your might. And these words that I command you today shall be on your heart. You shall teach them diligently to your children, and shall talk of them when you sit in your house, and when you walk by the way, and when you lie down, and when you rise. You shall bind them as a sign on your hand, and they shall be as frontlets between your eyes. You shall write them on the doorposts of your house and on your gates.*

This point is interesting because it shows the ability of the pro-individual liberty and anti-state convictions to transcend religious perspectives and find a way to unite people of divergent ethnicities and beliefs in an effort to preserve autonomy against the

76 Murray Rothbard, Education: Free And Compulsory 43 (1971).

77 Robert Dale Owen And Frances Wright, Tracts On Republican Government And National Education 16 (1847).

78 *Id.*

state and international law rules that violate the conscience of individuals across the world.

Homeschooling lawyers and scholars in America have a clear distrust for anything international, as international law is associated with perceived hostility to homeschooling families. Mike Farris (perhaps the biggest name in all of homeschooling and the popular voice for homeschooling rights across the world) of the Home School Legal Defense Association warily views the Convention on the Rights of the Child[79] as statism sneaking in as the trojan horse:

> *Article 3 (1) provides that in all actions concerning children, all decision-makers need to employ the legal standard known as the best interests of the child. What this means is that the government can substitute what it thinks best for that of the parents in every situation.*
>
> *Article 12 (1) declares that the child's views must be taken into account in every situation.*

When we read further, it means, taken into account by the government, because they're the ultimate decision-makers. In two very important areas of parental choice- religion and education- the CRC interferes with parental choice and elevates a child's wishes over that of the parent. Realistically, it is neither parents nor children who make the final decision in the case of conflict. The state has the power and duty under the CRC to make ultimate choices for kids.

It is important to note that most anarcho-capitalists do not see family rights as collective rights but rather as an institutional protection against encroaching state power. It is also true that while not all anarcho-capitalists (especially modern ones) subscribe to the patriarchal family clan mentality, most do agree that the individual rights of the children supersede those of the state or of society and that the primary right of a child is to be free from governmental coercion, bullying and dictation.

The UN and EU make legal assumptions that anarcho-capitalists do not accept, namely that domestic states and international organizations have any claim to make on behalf of children against their parents, churches or communities, that children deserve rights that others do not, and that the best interest of the child can be sought, defined and enforced apart from their identity as a member of a family. In his radical work "Education: Free and Compulsory" Rothbard states "The key issue in the entire discussion is simply this: shall the parent or the State be the overseer of the child"?[80] This clash of perspectives can best be seen in the European Court of Human Rights case of *Konrad and Others vs. Germany*.

Homeschooling families comprise a small but committed religious minority group in Germany, represented by only approximately 400 families who are in either hiding or

79 Hereinafter CRC.

80 *Supra* note 76 at 9.

being persecuted by the German state.[81] Adolf Hitler formally banned homeschooling in Germany in 1938 and this law has never been repealed. In January of 2008, this law was enforced in a manner uncomfortably reminiscent of Germany's shameful past when German government officers again persecuted a religious minority group by raiding the home of the Gorber family and taking five children by force into government custody. The children were finally returned to their parents ten horrifying months later and were forced to enroll into local public schools. After reviewing all court documents, the Home School Court Report Journal sums up the German government's case in this way:

> *According to the interpretation of the German courts, homeschoolers, by withdrawing their children from public education, subvert the state's effort to foster pluralism and tolerance. This threatens what the state sees as its interest to create responsible citizens.*

Unfortunately, the Gorber case represents just one of many of the German government's attempts to persecute homeschooling families. The most famous of these cases is the case of *Konrad and Others vs. Germany*.

After threats, harassment and intense persecution by the German government, the Konrad family attempted to appeal the Nazi-era law that required that their children attend school by applying to the European Court of Human Rights.[82] The Konrads claimed protection under Articles 8 and 9 and of Article 2 of Protocol 1 of the European Convention on Human Rights, which says that:

> *No person shall be denied the right to education. In the exercise of any functions, which it assumes in relation to education and to teaching, the State shall respect the right of parents to ensure such education and teaching is in conformity with their own religious and philosophical convictions.*

Shockingly the Court sided with the German government. Space prohibits a detailed analysis of the case, but in summation the Court stated that the interests of the state to be comprised of educated and socialized citizens and the right of a child to receive a state-approved education trumped any complaint that the Konrad parents brought and that the enshrinement of education mentioned in the articles was only state-sanctioned education alone.

Ironically, it was an American immigration Judge Lawrence O. Burman who took the opportunity during yet another German homeschooling case to lecture the German courts on human rights when agreeing to grant the family political asylum:

> *However, the rights being violated here are basic human rights that no country has a right to violate… Homeschoolers are a particular social group that the German government*

81 Bob Unruh, *Teaching Children Gets Parents Ordered Into, available at* http://www.wnd.com/index.php?fa=PAGE.printable (last visited April 16, 2011).

82 Hereinafter ECoHR.

> *is trying to suppress… This family has a well-founded fear of persecution … therefore, they are eligible for asylum … and the court will grant asylum.*[83]

Adding a nice parting shot, he said that the attitude of Germany and the ECoHR towards Germany's homeschooling minority is "repellent to everything we believe as Americans." If a country that does not usually adhere to the notion of sprawling human rights obligations of Europe is addressing the human rights deficiencies of the ECoHR, perhaps some introspection on this issue is due. Applying a minimalist and anarcho-capitalist cirtique of the ECoHR may help the court to better address the human rights of Europe's homeschooling minority in the future.

In this case, we see the collision of worldviews previously described by Rothbard. To whom does the burden of educating children belong? Are rights collective or individual? Does the state or the family come first? Is there a positive obligation of parents to enroll their children in school or do the parents have a right to not have the government interfere in their homeschooling practices? Germany and the ECoHR believe that the state takes precedence over the rights of the family (though they mentioned that they did not challenge the quality of education that the homeschooled child would receive; only that they would be poorly socialized and integrated because of it). Where international law refuses to protect the right of choice in education (yet supporting the right of choice in countless other matters), the ECoHR is seen by anarcho-capitalists as bankrupt in terms of being able to properly defend the individual liberties and rights of the people of Europe. The ECoHR is immediately shunned by anarcho-capitalists as the worst example of judicial activism, ruthless collectivism and blatant socialism currently on display anywhere in the world today. The anarcho-capitalist refuses to acknowledge the jurisdiction of a court that has put the rights of the collective society above that of a peaceful citizen, especially when the court purports to have been established to vindicate individuals whose human rights have been abridged by states within the EU.

One shudders to think what Mises, Rothbard and Hayek would say about the ECoHR and the Konrad case. To see the EU apparatus allow for such a ruling would make a loyal anarcho-capitalist give up on the EU, the Council of Europe and their systems of courts all together. Though domestic governments everywhere can be terribly oppressive, Germany has outrageously persecuted their minority homeschooling population. Rothbard, never one to shy away from hyperbole, was perhaps thinking of cases like this when he famously discussed the future of governments as "a boot stomping on a human face, forever".[84] For a human rights court to essentially hold down the Konrads so that they could be stomped further would make the ECoHR (along with the laws set up by the German government which previously drove Mises out of Austria in 1934) an enemy of Mises, Rothbard and their followers.

83 *See* www.hslda.org/docs/media/2008/200808080.asp.

84 Murray Rothbard, *Our Future*, 4 Analysis Mag. (September 1949).

For international law to be used as a weapon of a state to abridge the personal and individual liberties of its people represents to the anarcho-capitalist a colossal and alarming failure. The preference of the ECoHR for state government interests over individual conscience is the antithesis of the anarcho-capitalist teachings of Mises, Rothbard and Hayek. It proves what anarcho-capitalists have long suspected: that European judicial human rights activism is often a crusade for statism masquerading as collective rights protectionism.

VIII. Conclusion

I have attempted to keep my critique tailored, orderly and tightly focused. It is my hope that the perspectives offered in this discussion of an admittedly small group of legal entities, regimes and court decisions would in the future be further applied by other writers to the broader global integrated legal order. The principles of the Austrian school including non-aggression, unfettered free trade, anti-collectivism, individual autonomy and many others make for what I feel is a deep and interesting critique of the current direction of international law. I have attempted to discover if a well-reasoned critique of international law from the Austrian perspective is compatible with a realistic and effective approach to international peace and order. My findings suggest that while significantly better than some domestic law systems, in its current expression and manifestation public international law (especially international human rights law) fails to adequately provide individuals with the level of protection necessary to secure for them the libertarian ideal of individual autonomy, personal sovereignty and unfettered liberty.

It should not surprise us that this is so, as the goals of anarcho-capitalism are laudably (and some might say impossibly) high. The detractors of anarcho-capitalism (which would include the majority of mainstream economist, historians and legal scholars) contend that the anarcho-capitalist ideal represents an untenable "rich man's paradise" that is unworkable in the machinations of today's modern and complex civil society.

Unfortunately, I feel that anarcho-capitalism and international law are, for the most part, essentially incompatible. They are completely opposite to each other in their intrinsic vision for what the law should do. For the true believer in international law, the law exists to include as many people as possible by issuing positive protections including restraining if necessary market forces and the influence of unequal wealth and inequality wherever it is found. It exists to make and keep peace through its obligations and influence. Dr. Ted Carpenter of the Libertarian think-tank The Cato Group speaks for many frustrated anarcho-capitalists when describing the UN and by extension international law in the following terms:

> *The organization is plagued by problems of mismanagement and corruption. Much of the UN's energy and funds has been devoted to pushing such pernicious measures as the*

> *Law of the Sea Treaty and holding pretentious summits on the environment, world population, and other issues. Delegates to those boondoggles invariably embrace the discredited notion that more government intervention and regulation are the solution to any problem.*[85]

For the anarcho-capitalist, international and domestic law should exist only as a check against state power and as a means to protect and preserve private property for the individual. To them, equality is the language and mission of socialism. Equality is theft. What is desired is to be left alone, to be free in your autonomy with no social contracts or positive obligations of any kind. Liberty is not a public policy or an entitlement benefit prescribed by a leviathan government or international body, but quite to the contrary, it is the absence of the coercive bureaucracy that is true liberty.[86] It has been said that the majority of international lawyers believe that most states obey international law most of the time.[87] This voluntary cooperation is far superior to the violent and coercive nature of most domestic legal systems and anarcho-capitalists should respect and encourage this aspect of international law.

Of course, theory (or critiques) and experience are not the same thing. It is entirely probable that many regions (Europe in particular) have descended too far into the socialized welfare bureaucracy and international commitments (such as the ECoHR) for the idealistic anarcho-capitalists and libertarians to ever gain any real ground there. With the current European regime, a drastically minimalist approach to international law sadly seems thoroughly unworkable. It would require a complete redefining of what governments and international bodies are and would require at least one generation before Europeans could begin to attempt to appreciate much less government. It would also require the repeal of so much EU legislation that the EU human rights regime would perhaps need to be abolished as a whole. So, for now, the anarcho-capitalist critique is essentially an academic exercise (which is not to say that the current model would not benefit from an energetic injection of free market ideas and the serious protection of individual liberties; I think that it would).

It is my desire that international law and anarcho-capitalism find a common ground in opposing tyrannical domestic states in an effort to secure freedom for each of the world's citizens. Though a drastic and oftentimes overwhelming worldview, the anarcho-capitalist perspective can at the very least define the individual as a human being with immense importance, vested with rights that pre-exist states and governments. With this in mind, anarcho-capitalism can be a force for human rights protections across the international community. I would like to see a compromise and have individual liberty

85 Ted Galen Carpenter, The United Nations Cato Policy Report 1 (February 1997).

86 Llewellyn Rockwell Jr, *It's Time To Rethink Everything*, *available at* http://www.lewrockwell.com/rockwell/rethink-everything175.html (last visited April 10, 2011).

87 Michael Ignatieff, *America The Mercurial, available at* http://www.legalaffairs.org/issues/March-April-2005/review_ignatieff_marapr05.msp (last visited April 10, 2011).

more properly protected while still providing perhaps a voluntary market-driven safety net for those less fortunate than others.

I feel that if the best ideas of anarcho-capitalism (namely anti-aggression, individual autonomy, private property protections, freedom of choice in all areas of life, true free expression and jurisdictional boundaries when viewing families and the private market) can be clearly offered to individuals in the framework of international law (being embraced and dispensed from institutions like the UN, EU, CoE, ICC and ICJ) then the freedoms of both the individual and the states of the world will be better equipped to confront the international legal challenges of the day through respect for the individual and the valuation of high international standards of liberty and justice. Until that day comes, anarcho-capitalism can serve as one of many critiques that, when properly applied, can help to mould international law into the best version of itself.

Taxing Controlled Foreign Corporations In India – Flashlights Or Distress Signals?

Sanjhi Jain[*]

Abstract

This paper targets the introduction of Controlled Foreign Corporations Regulations [CFC] in the Direct Taxes Code, 2010. The CFC regime seeks to make taxable in India, the deferred passive income of a corporation incorporated outside India, usually in tax havens like Luxembourg and Cayman Islands but, owned or controlled by a resident of India. The undertone of the new regime is thus, anti-tax avoidance measures that are expected to result in the widening of the Indian tax base. The CFC framework is well established in jurisdictions like the United States, United Kingdom and Germany, which are capital-exporting countries. The import of the CFC idea to a largely capital-importing jurisdiction such as India appears to be a premature and hurried attempt. The proposed regulations, coupled with the redefined concept of residence of a company incorporated outside India might adversely impact both offshore investments and foreign direct investments into India. The possibility of double taxation cannot be ruled out either. The debate surrounding the CFC regulations has two tiers. Tier one questions the allocative efficiency of the CFC regime for India and considers its feasible alternatives. Tier two assumes that the CFC regime is workable for India in the long run, and thus critically analyses the provisions of the DTC in this regard while suggesting amendments.

Introduction

The halls of Indian tax policy these days are charged with the question of unearthing information on black money stashed in tax havens, requiring the overhauling of several wings of tax laws, such as service tax and generally, increasing the resource base for taxation revenue, particularly through a crackdown on tax avoidance measures. One of these policy initiatives is the proposed tax on Controlled Foreign Corporations[1] set to come into effect in the new Direct Taxes Code[2] from April 1, 2013.

It is a time-honoured principle of corporate law that a corporation is to be considered a legal entity, distinct from its shareholders.[3] Thus, while the corporation is subject to taxation law, at the shareholders level, taxation rules do not apply until the income is distributed as dividends to the shareholders.[4] This scheme of the 'incorporated

* B.A. LL.B. (Hons.), NALSAR University of Law, Hyderabad. I thank Ms. Neha A. Pathakji, Assistant Professor of Law at NALSAR and the Board of Editors at NSLR for helpful comments on earlier drafts of this article.

1 Hereinafter CFC.

2 Hereinafter DTC.

3 Salomon v. A. Salomon & Co. Ltd., (1897) AC 22.

4 Organization for Economic Cooperation and Development: Working Party on Tax Policy Analysis and Tax Statistics, 'Tax Burdens: Alternative Measures' (2000).

pocketbook'[5] has become one of the most prevalent forms of tax avoidance and is often referred to as 'deferral.'[6] Deferral of income by storing it away in the foreign corporation controlled by the Indian resident thus results in delayed taxation where the income can be taxed only when the Indian shareholder receives it as dividends.

The CFC Regulations, also called Anti-Deferral Rules, first made an appearance in United States tax laws. In as early as 1913, tax deferral was allowed on most types of foreign subsidiary income.[7] In 1961, in a message to the Congress, the then President John F. Kennedy stated thus:

> *The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland…I therefore recommend that legislation be adopted which would, after a two-step transitional period, tax each year American corporations on their current share of the undistributed profits realized in that year by subsidiary corporations…*[8]

In 1962, the US enacted Sub Part F in the Revenue Act, 1962 which serves as an anti-deferral code. In what has been labelled 'race to the bottom' in corporate taxation,[9] capital-hungry economies, in order to attract investment, set their tax rates to dangerously low levels. This, in turn, invites reactions from other nations that lower their taxes further and a chain reaction is triggered with countries engaging in harmful tax competition. They end up eroding their own tax base and adversely influencing tax policies of other jurisdictions.[10] The Organization for Economic Cooperation and Development[11] noted the necessity to incorporate CFC rules to counter not only legitimate transfer of passive income but also harmful tax competition.[12] In a CFC regime, low tax rates will be redundant or at least less effective as an incentive to defer corporate incomes to a jurisdiction with a more beneficial tax structure. The CFC framework thus, could potentially counteract the disastrous impacts of policies of tax haven countries.

Section 115-O of the Indian Income Tax Act, 1961 taxes only on the distributed profits of domestic companies. Presently, there are no provisions in force to check deferral

5 H.R. Rep. No. 704, 73d Cong., 2d Sess. 1 (1934) (1934 House Report). *See* in Office of Tax Policy Department Of Treasury, The Deferral of Income Earned Through US Controlled Foreign Corporations – A Policy Study (2000), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/subpartf.pdf.

6 Robert E. Meldman & Michael S. Schadewald, A Practical Guide to U.S. Taxation of International Transactions 601 (1996).

7 Glen M. Secor, *Runaway Plants, Runaway Tax Policy: The Continuing DebateOver the Taxation of Controlled Foreign Corporations*, 16 Suffolk Transnat'l L. Rev. 200 (1992-1993).

8 John Fitzgerald Kennedy, President, United States of America, 'Special Message to the Congress on Taxation' (April 20, 1961), *available at* http://millercenter.org/scripps/archive/speeches/detail/5669.

9 Organization for Economic Cooperation and Development, 'Harmful Tax Competition- An Emerging GlobalIssue'(1998), *available at* http://www.oecd.org/dataoecd/33/0/1904176.pdf.

10 *Id.*

11 Hereinafter OECD.

12 *Id.*

of income and the consequent tax avoidance as described above. The purpose that the new CFC regime seeks to achieve lies in attracting into India the deferred passive income of a corporation incorporated outside India, usually in tax havens like Mauritius, Luxembourg and The Cayman Islands, but owned or controlled by an Indian resident.

Presently the foreign income of a controlled foreign corporation does not become subject to taxation unless it is repatriated to the concerned jurisdiction in the form of dividends paid to the resident.[13] In a CFC regime however, the subject of taxation is that income of a corporation (incorporated abroad but controlled by an Indian resident), which is not distributed as dividend to the shareholders but is deferred to the next year. The undertone of the new regime is thus to check tax avoidance which is expected toplug the leakage of tax and thereby result in the widening of the Indian tax base.

Pertinently, a CFC is not necessarily a storehouse for black money or illicit financial flows stashed abroad in tax haven countries.[14] While the morality or otherwise of tax avoidance itself is beyond the scope of this paper,[15] it has been succinctly observed by the Supreme Court of India:

> *My Lords, of recent years much ingenuity has been expended…to devise methods of disposition of income by which those who were prepared to adopt them might enjoy the benefits of residents in this country…without sharing in the appropriate burden of British taxation. Judicial dicta may be cited which point out that…those who adopt them are entitled to do so. There is, of course, no doubt that they are within their legal rights…one result of such methods…is of course to increase pro tanto the load of tax on the shoulders of the great body of good citizens who do not desire or do not know how, to adopt these manoeuvres.*[16]

Thus, tax avoidance through deferral measures is not *per se* illegal, since there are no laws yet in place prohibiting such deferral. Yet, a CFC regime is warranted because

---

13 Ashutosh Chaturvedi & Dheeraj Chaurasia, *Controlled Foreign Firms: Is This The Last Resort*, The Business Standard (February 20, 2012), *available at* http://www.business-standard.com/budget2012runup/news/controlled foreign-firms-is-this-last-resort/465174/.

14 India has recently entered into a Tax Information Exchange Agreement [TIEA] with the British Virgin Islands according to which India can seek information about the alleged black money parked in British Virgin Islands by Indians. *See India signs Tax treaty with British Virgin Islands*, The Hindu (February 10, 2011), *available at* http://www.thehindu.com/business/article1327627.ece. The first TIEA was signed with Bermuda and another with the Isle of Man. More such agreements are in the offing.

15 *See* Leonard Hoffman, *Tax Avoidance*, 2 British Tax Rev. 197-206 (2005) where Lord Hoffman highlights thebasic difference between tax evasion and tax avoidance by noting that tax avoidance cannot be said to be contrary to the intentions of the legislature which intention is visible in the text of a statute. "…sometimes there are holes….and the courts find they cannot plug them by appealing to the economic event,which……it appears that Parliament wished to tax. It is one thing to give a statute a purposive construction.Itisanother to rectify the terms of a highly prescriptive legislation in order to include provisionswhichmight have been included but are not actually there." *See also* G.S.A. Wheatcroft, *The Attitude of the Legislature and the Courts to Tax Avoidance*, 18(3) The Mod. L. Rev. 209 (May 1955).

16 Lord Simon in Latilla v Inland Revenue Commissioners, 1943 AC 377, as cited by O. Chinappa Reddy, J. in his concurring opinion in McDowell and Co. Ltd. v Commercial Tax Officer, 1985 (3) SCC 230, ¶35.

tax avoidance is undesirable from the point of view of national interest and should be discouraged by the legislature.[17]

The CFC framework is well established in jurisdictions like the United States, United Kingdom and Germany that are capital-exporting countries. The wisdom in importing the concept of CFC Regulations into a largely capital-importing jurisdiction such as India is under intense debate and is being alleged as a premature and hurried attempt.[18] Concerns are running high that the proposed regulations, coupled with the redefined concept of 'residence' of a company incorporated outside India, might adversely impact both offshore investments and foreign direct investments into India. The possibility of double taxation cannot be ruled out either. Certain institutions such as the Bombay Chartered Accountants Society have advocated a double tax credit system in place of the CFC rules to achieve the desired end of repatriation of profits earned abroad.[19]

The debate surrounding the CFC regulations has two tiers. Tier one questions the allocative efficiency of the CFC regime for India and considers feasible alternatives. Tier two assumes that the CFC regime is workable for India in the long run, and therefore critically analyses the provisions of the DTC in this regard and suggests amendments. This paper is an attempt to comprehensively realize the tasks outlined in Tier two with the first tier occasionally figuring in at relevant junctures.

I. Models To Check Deferral Of Active Income

The following are some methods that have been in active use alongside the CFC rules in several jurisdictions. These systems govern taxation of active business income as opposed to passive income of the CFCs. Active income is that income of a foreign corporation which is derived from its primary business activities, whereas passive income includes income derived from all other sources like dividends, rents, royalties, etc. Whether the CFC framework should cover in its ambit the active income is a different debate beyond the scope of this paper.

A. Exemption System

Under this system, if the income of the foreign corporation is repatriated to the parent company's country, the dividend is exempt from tax.[20] Thus, only the foreign

17 G.S.A.Wheatcroft, *supra* note 15.

18 Shyamal Mukherjee, *Regulations on Controlled Foreign Corporations: Are We Ready?*, Business Standard (June 21, 2010),*available at* http://www.business-standard.com/india/news/regulationscontrolled-foreign-corporationsweready/23/02/398921/. Shyamal Mukherjee is Executive Director & Joint Leader of Tax Practice, PricewaterhouseCoopers. *See* 'Statement on Controlled Foreign Corporation (CFC) Rules', Prepared by the Task Force on CFC legislation, International Chamber of Commerce, *available at* http://www.iccwbo.org/policy taxation/id537/index.html.

19 Declan Gavin, *Worldwide tax view - Controlled foreign corporation regimes*, Bombay Chartered Accountants Society (December 2007), *available at* http://www.bcasonline.org/articles/artin.asp?742.

20 Samuel C. Thompson, Jr., *Assessing the Following Systems for Taxing Foreign-Source Active Business Income: Deferral, Exemption and Imputation*, 53 How.L.J. 337, 341 (2010).

jurisdiction taxes the dividend of the CFC. Countries like France, Germany, Australia and Netherlands follow an exemption system in one form or another. The laws of these countries generally diverge in so far as the type of foreign source income that is exempt from the parent country's tax laws.[21] This system places the CFCs on the same platform as other foreign corporations in the concerned foreign jurisdiction. The CFCs are thus, ensured competitiveness and capital import neutrality[22] where the incomes of all corporations located within a particular locality or nation are taxed at a uniform rate irrespective of the country of residence of the owners of such corporations. However, in an exemption framework, the parent corporation has a greater incentive – than it would have in an anti-deferral regime – to divert more and more income to the CFC located in the low-tax jurisdiction, then repatriate it to the home country and avoid considerable amounts in tax. Thus, the exemption system also provides perverse incentives for transfer pricing abuse.

B. Imputation System

In this system, the CFC is treated as a foreign branch of the parent corporation and is subject to domestic taxation in the parent corporation's country of residence.[23] The tax treatment is much the same as in the case of a partnership and the income is imputed to the owners of the corporation who are then taxed.[24] To prevent situations of double taxation of the CFC, both in its country of incorporation and in the parent corporation's country of residence, the imputation system generally has provisions for foreign tax credits. The imputation system promotes capital export neutrality[25] wherein the corporation is taxed for the same amount irrespective of where the investment is made or the income is earned. It also preserves the tax base of the parent corporation's country of residence.[26] However, it raises administrative costs and decreases the competitiveness of the CFCs. On October 9, 2009, New Zealand switched to exemption from imputation citing the need to put New Zealand businesses on an equal footing at the international level.[27]

---

21 Government Accountability Office, Report to the Commission on Finance: U.S. Senate Study Countries that Exempt Foreign-Source Income Face Compliance Risks and Burdens Similar t Those in the United States, GAO-09-934 6 (Sep. 2009) as cited in Samuel C. Thompson, Jr., *Assessing the Following Systems for Taxing Foreign-Source Active Business Income: Deferral, Exemption and Imputation*, 53 Howard L. J. 337 (2010).

22 Peggy B. Musgrave, *Capital Import Neutrality*, *in* Encyclopaedia of Taxation and Policy 50 (Joseph J. Cordes et al ed., 2005).

23 Samuel C. Thompson, Jr., *supra* note 20 at 341.

24 Samuel C. Thompson, Jr., *supra* note 20.

25 Peggy B. Musgrave, *Capital Export Neutrality*, *in* Encyclopaedia of Taxation and Policy 45 (Joseph J. Cordes et al ed., 2005).

26 Samuel C. Thompson, Jr., *supra* note 20.

27 Mary Swire, *New Zealand Forges Ahead with International Tax Reform*, Tax News (October 23, 2007), *available at* http://www.tax- news.com/news/New_Zealand_Forges_Ahead _ With _International _Tax _Reform _____28766.html.

II. Worldwide Legal Regime On Cfcs

A. United States Of America

The United States pioneered the enactment of the CFC rules. Since 1962, the law has evolved from treating CFCs as a partnership for the purposes of both active and passive income to taxing deemed dividends. The law relating to CFCs is contained in Subpart F (Sections 951 – 965) of the Internal Revenue Code. The taxable income, also called Subpart F income, is defined and categorized into various heads like insurance income, foreign base company income, foreign company holding income, etc. and for each of these categories, a *de minimis* threshold is prescribed which can be excluded from Subpart F income.[28] Section 954(c) defines foreign personal holding income that includes dividends, rents, royalties, annuities and certain property transactions. A shareholder owning 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation, is liable to tax under Subpart F. Section 960 has special rules for foreign tax credit. Section 965 of the Internal Revenue Code enacted as part of the American Jobs Creation Act, 2004 offers a reduced tax rate on distributed dividends, from 35% to 5.25%, to companies, in a bid to encourage repatriation. The Stop Tax Haven Abuse Act – introduced by Senator Carl Levin in the Senate in 2007[29] – recommends that foreign corporations, managed and controlled in the United States, be treated as domestic corporations, thus, arguing for an imputation system for passive income of the CFCs and almost going back to the first leg of the CFC regime back in 1962. The US regime has often been criticized for being overly complex.[30]

B. United Kingdom

Sections 747–756 and Schedule 25 of the Income and Corporation Taxes Act, 1988 contain the British law on CFC. Provisions akin to the motive test have been included, which mandate an enquiry into why the CFC was set up, whether it was only for the purpose of avoiding UK tax, etc. A wide definition of 'control' has been provided according to which UK residents holding more than 50% interest in the company or a UK resident holding 40% or more and a non-resident holding 40%-55% interest in the foreign corporation are subject to CFC rules. CFCs whose UK chargeable profits would be below £50,000 per annum have been excluded from the CFC regime. Acquisitions

28 The *de minimis* threshold is provided in Section 953 for Insurance income and in Section 954 for Foreign Base Company income.

29 The earlier draft of the bill was read twice and referred to the Committee on Finance. In July 2011, a new draft was introduced in the U.S. Congress by Representatives Lloyd Doggett, Sander Levin and Rosa DeLauro. *See Reps. Doggett, Levin, DeLauro Introduce Bill To Stop Abuse of Tax Havens*, *available at* http://doggett.house.govindex.php?option=com_content&view=article&id=352:summary-of-rep-doggetts-stop-tax-haven-abuse-act&catid=49:latest-news&Itemid=149.

30 *See generally*, David Myers, *Section 482 and Subpart F: An Internal Revenue Code Dilemma*, 11 Am. U. J. Int'l L. & Pol'y 1073 (1996), *See also* Daniel P. Shepherdson, *The Simplification of Subpart F*, 17 Case W. Res. J. Int'l L. 459 (1985).

of certain subsidiaries from third parties that have not been previously controlled in UK have also been exempt for up to two years.

The following proposals for reform are considered under the Finance Bill, 2012:[31]

1. introduce an exemption for certain intra-group trading transactions where there is little connection with the UK and therefore, unlikely that UK profits have been artificially diverted;
2. introduce an exemption for CFCs with a main business of intellectual property (IP) exploitation, where the IP and the CFC have minimal connection with the UK;
3. introduce a statutory exemption which runs for three years for foreign subsidiaries that, as a consequence of a reorganisation or change to UK ownership, come within the scope of the CFC regime for the first time;
4. amend the conditions of the current *de minimis* exemption; to increase the limit for large groups from £50,000 to £200,000 profits per annum.

The UK is in a continuous process of reforming its CFC law. According to the latest update by the Revenue and Customs department,[32] a three-pronged test is proposed to identify profits that are outside the CFC regime: the UK activities test[33], the capability and commercial effectiveness test[34] and the tax purpose test[35].

C. Brazil

The CFC regime in Brazil is highly interesting albeit drastic. There is no exemption provided for the active business carried on by the CFC. Irrespective of the percentage of ownership, the shareholder must include in its taxable income a proportionate share of the undistributed dividends from a CFC that has not been taxed in Brazil.[36] Thus, the word 'controlled' appears to be a misnomer with respect to the Brazilian law on CFCs.[37] Regardless of the existence of a tax treaty, all foreign taxes paid by the CFC are creditable in Brazil.[38]

D. The Organization For Economic Cooperation And Development

The OECD has prepared a Model Tax Convention on Income and on Capital[39] which lays out a framework to settle common issues across jurisdictions regarding

31 *Part IIIA: Controlled Foreign Company (CFC) interim improvements*, *available at* http://www.hm-treasury.gov.uk/d corporate_tax_reform_part3a_cfc_interim_improvements.pdf.

32 *See* HM Revenue & Customs, 'Controlled Foreign Companies (CFC) reform: a Gateway update', February 2012.

33 This condition is met unless the control and management of a foreign subsidiary is carried on to a significantextent in the UK.

34 This test is satisfied if the foreign subsidiary has the capability to carry on its business without the UK activities mentioned earlier.

35 This condition is met if the main purpose of the arrangement is not achieving a UK tax reduction. This condition is similar to the motive test.

36 Amanda D. Johnson, Brazil Tax, Law and Business Briefing 31 (2005).

37 *Id.*

38 *Id.*

39 The Model Convention was first released in 1992 and has been periodically updated since then.

international double taxation. The provisions relevant to this paper are the following:

Article 7(1) provides that a Contracting State can tax the profits of an enterprise of another Contracting State only when such an enterprise carries on business in the taxing Contracting State through a permanent establishment situated in such a State. The relevant portion of Article 10(5) provides that a Contracting State may not tax the undistributed profits of a company resident in another Contracting State even if such profits wholly or partly arise in the taxing Contracting State.

The OECD Commentary on the Model Tax Convention notes that arguably, the CFC regime violates the above provisions of the Convention in that the CFC rules authorize a State to tax the undistributed profits of an enterprise situated in another Contracting State and which is not a permanent establishment of any enterprise of the taxing Contracting State. The Commentary summarily rejects these arguments and notes that the CFC rules and the double taxation avoidance treaties operate in different spheres and therefore do not conflict with one another.[40] Ireland, Belgium, Switzerland, Netherlands and Luxembourg have noted their disagreement with the OECD's view.

III. India: The CFC Regime In The Direct Taxes Code

The DTC is the Indian answer to the complexity and high administrative costs associated with the collection of direct taxes, particularly income tax. The DTC aims at streamlining the tax-collection procedure and lessening, if not wiping out altogether, the inefficiencies and loss of revenue which an intricate tax structure will not bring.

In January 2003, a Working Group headed by the then Director General of Income Tax for International Taxation, Mr. Vijay Mathur, released a Report on Non-Resident Taxation [Vijay Mathur Report].[41] The Report noted that owing to the increase in outbound investments, the enactment of CFC rules was imperative to prevent Indian companies from parking profits in low or no-tax jurisdictions and thereby, deferring Indian tax.[42] In an appendix, the Report also provided a comparative overview of the working of CFC regulations in USA, UK and Finland.[43]

In June 2010, in the Revised Discussion Paper on the DTC issued by the Central Board of Direct Taxes under the Ministry of Finance, it was recommended that in line with internationally accepted practices, CFC rules should be introduced providing that the passive income of the foreign corporation, which has not been distributed to the shareholders, will be deemed to have been distributed and the deferral of tax can therefore be contained.

40 The OECD, Model Tax Convention on Income and Capital, July 2010, Commentary on Article 1, ¶ 22.1.

41 Ministry of Finance Government of India, Report of the Working Group on Non-Resident Taxation, *available at* www.finmin.nic.in/reports/NonResTax.pdf. Hereinafter 'the Vijay Mathur Report'.

42 *Id.*

43 *Id.*

The following are the relevant provisions of the DTC which provide for a CFC framework in India:

> Clause 58(2)(u) provides that the gross residuary income shall include "any amount of attributable income of a controlled foreign company to a resident in accordance with the Twentieth Schedule."
>
> Clause 59(1)(c) provides that any amount received during the financial year as dividend from a CFC, to the extent such amount has been included in the total income of the assessee in any preceding financial year in accordance with the provisions of the Clause 58(2)(u), is to be considered to arrive at the deductions for the purposes of computation of income from residuary sources.

The Twentieth Schedule provides for the method of computation of income attributable to a controlled foreign company.

According to Clause 113(2)(k) in Part E, Chapter X of the DTC, any preference or equity shares held by a resident in a controlled foreign company, as referred to in the Twentieth Schedule, are to be considered 'specified assets' for the computation of 'net wealth' under Clause 112 for the purposes of wealth tax.

Generally, under Indian law, between the domestic tax law and a double tax avoidance agreement[44] or treaty, that which is more beneficial to the assessee is considered applicable.[45] However, in the Revised Discussion Paper on the DTC, it was proposed that the CFC provisions should have precedence over the application of the DTAAs. This recommendation has been incorporated in Clause 291(9)(c) according to which, whether or not the CFC regulations are beneficial to the assessee, they shall apply to him. This provision erodes the effectiveness of the DTAA when it comes to controlled foreign companies. Domestic taxation law will thus, continue to apply to these corporations despite the existence of a DTAA.[46]

A. Controlled Foreign Corporation

According to Paragraph 5(a) of the Twentieth Schedule, a 'Controlled Foreign Company' means a foreign company that satisfies five conditions:

i) *Resident of low tax territory*: It is a resident of a territory outside India that has a lower rate of taxation. 'Territory with lower rate of taxation' is further defined

44 Hereinafter DTAA.

45 The Income Tax Act, § 90 (1961).

46 The OECD in its Model Tax Convention on Income and Capital noted that once rules like CFC have been incorporated in the domestic law, a State is unlikely to be a part to bilateral tax conventions like DTAAs and is also unlikely to interpret the existing conventions in a manner contrary to the CFC rules. *See* the OECD, Model Tax Convention on Income and Capital, July 2010, Commentary on Article 1, ¶ 7.1, , the OECD. The Indian legislature, by giving a superseding effect to the CFC rules over the DTAAs, confirms the OECD view.

under Paragraph 5(d) of the Twentieth Schedule to mean a territory or country outside India according to the laws of which the amount of tax payable on the profits of a company is less than one half of the corresponding tax payable in India if that company were a domestic company. Thus, territories with lower rate of taxation may or may not be tax havens.[47]

ii) *Control*: One or more persons, resident in India, individually or collectively exercise control over the company. Paragraph 5(b) provides that one or more Indian residents are said to exercise control of the CFC if they either individually or collectively, possess or are entitled to acquire, directly or indirectly, shares carrying 50% or more of the voting power or capital of the CFC; or they are entitled to secure that 50% or more of the income or assets of the CFC be directly or indirectly applied for their benefit; or they exercise dominant influence on the CFC due to a special contractual relationship; or they have sufficient influence to exercise decisive influence in a shareholder meeting of the CFC.

iii) *Public listing*: The shares of the CFC are not traded on any stock exchange recognised by the law of its country of residence for the purposes of tax.

iv) *Active trade or business*: The CFC is not engaged in any active trade or business. According to Paragraph 5(a) of the Twentieth Schedule, only a company that is not engaged in active trade or business is to be considered a controlled foreign company. Paragraph 5(e) of the Twentieth Schedule lays down the kinds of income that are considered to be income from 'active trade or business' carried on by a company. Illustratively, this list includes active participation in the industrial, commercial and financial undertakings in the economic life of the low tax territory in which the foreign company is a resident for tax purposes. It also includes income, as long as such income is less than 50% of the income of the said company during the relevant accounting period; from dividends, interest, house property, capital gains, royalty, annuity, sale or licensing of intangible rights in literary, artistic or industrial property, etc.

v) *De Minimis for income*: The specified income of the CFC, to be determined in accordance with Paragraph 4 of the Twentieth Schedule exceeds 25 lakh rupees. This is the income threshold or the *de minimis* limit for a CFC to fall within the ambit of the framework prescribed under the Twentieth Schedule.

47 Contrary to the popular perception, tax havens are not just low-tax jurisdictions. Most corporations prefer operating from tax havens because the laws there offer secrecy that allows them independence in business operations, and allegedly, in commission of tax fraud. Indeed, tax havens are labeled "offshore secrecy jurisdictions" under the Stop Tax Haven Abuse Act introduced in the United States. *See supra* note 20. *See also* Robert M. Morgenthau, *These Islands Aren't Just a Shelter From Taxes*, New York Times (May 5, 2012), *available at* http://www.nytimes.com/2012/05/06/opinion/sunday/these-islands-arent-just-a-shelter-from-taxes.html?_r=1. *See also* Nicholas Shaxson, *The Tax Haven in the Heart of Britain*, New Statesman, February 24, 2011, http://www.newstatesman.com/economy 2011/02/london-corporation-city.

IV. The Troubled Waters Of An Unpromising Territory- Controversial Features Of The DTC Regime On CFC

According to the International Chamber of Commerce, protection of the national tax base through a CFC regime leads to economic inefficiency in the long run and transfer pricing rules are a better way of preserving the tax base.[48]

A. Grace Period To Newly Acquired Structures

It is likely that a company that has been newly set up or newly acquired may not generate sufficient active income in the initial few years despite being actively involved in trade or business. It is highly possible that such a company earns income through passive means like dividends, interest, etc.[49] In this scenario, the DTC offers no succour and the said company would be covered under the CFC regime. By taxing under the CFC rules, a company whose underlying purpose might not even be tax deferral, and which might have an excess of passive income over active income simply because it is grappling with the survival of its new structure, the DTC leads to a perverse implementation of the law which is required to be checked. It is therefore, necessary that an exemption be provided to newly acquired structures for at least two or three years, as also recommended in the UK Finance Bill, 2012, during which time the company can start functioning on a full scale. It will then be easier for the revenue department to investigate if the concerned company generates more of active or passive income.

At this point, the 'motive test' is of immense relevance. As stated by the European Court of Justice in the *Cadbury Schweppes case*, CFC rules should cover only those "cases where there is both (i) an intention to obtain a tax advantage and, objectively, (ii) the absence of an establishment carrying on genuine economic activities."[50] It is essential to incorporate the motive test in the DTC to tax only those CFCs that have tax deferral as their ultimate motive. The DTC presently contains the potential to stifle the growth of newly established or acquired companies that might be genuinely interested in carrying on active trade.

B. A Hurried Groundless Attempt?

As Frederick Bastiat once wrote: "the purpose of the law is to prevent injustice from reigning".[51] The anti-CFC quarters argue that historically, CFC rules have been used

48 The International Chamber of Commerce, *ICC Statement on Controlled Foreign Corporation (CFC) Rules*, *available at* http://www.iccwbo.org/policy/taxation/id537/index.html.

49 HP Agarwal, *CFC Rules under Direct Taxes Code Need Relook*, Business Standard (Dec 27, 2010), *available at* http://www.business-standard.com/india/news/cfc-rules-under-direct-taxes-code-need-relook/419640/.

50 Cadbury Schweppes plc & Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Judgment of the European Court of Justice in Case C-196/04, September 12, 2006 [Cadbury Schweppes case], ¶¶ 64-67. The case is explained later in the heading 'Role of the Judiciary'.

51 Frédéric Bastiat, The Law 19, (2007).

mostly by countries that primarily export capital like United States, Australia, etc. India being a net importer of capital, our inbound investment far exceeds outbound investment. Thus, India does not require enactment of this harsh law to check tax avoidance.[52] However, with the introduction of CFC rules in developing countries like Brazil, this argument does not hold water. What is more important to investigate is whether facts, data and statistical analysis mandate and justify a stringent CFC regime like the one we are concerned with.[53] To begin with, CFC rules would be urgently needed if it was found that outbound investments by Indian companies has increased significantly over a considerable span of time and that there is increased danger of Indian holding companies parking their profits in foreign subsidiaries, thereby resulting in huge losses in tax revenue to the Indian exchequer. This hypothesis warrants factual examination but unfortunately, this exercise has not been carried out in India. Until recently, there was no specific data available suggesting that investments in controlled corporations abroad by Indian residents had increased considerably. The data published by the Ministry of Finance on investment outflows was rather sketchy and a country-wide breakdown of the actual value of outflows was not available in the public domain.[54] It was only since the financial year 2008-2009 that the Reserve Bank of India started releasing such data in its monthly bulletin. A period of three years is too short an assessment period to necessitate a CFC regime in India.

Further, the only evidence asserting that foreign outflows from India were *expected* to surpass foreign inflows for a single financial year, i.e 2007-2008 lies in the lone study[55] conducted by the Associated Chambers of Commerce and Industry of India.[56] On the other hand, the UNCTAD notes that there has actually been a drop in outbound flows of equity investments from India.[57] Clearly, this insufficient and contradictory evidence cannot justifiably support the need for a whole new law marking a significant shift in the tax policy. The proposed CFC regime in India is thus, *a priori*. It is suggested that the Indian government should put the CFC law on hold until enough data accumulates and

52 HP Agarwal, *supra* note 49.

53 A cost-benefit analysis is indispensable in this regard. *See* Nishith Desai Associates, Direct Taxes Code GlobalThink Tank, *International Dimensions of the Direct Taxes Code Bill, 2010: Comments and Recommendations* (2011), *available at* http://www.nishithdesai.com/Budget2012 DTC%20Global%20Think%20Tank%20Report%20%28Summary%29.pdf.

54 Sasidaran Gopalan & Ramkishen S. Rajan, *India's FDI Flows: Trying to Make Sense of the Numbers*, 5 *Alerts on Emerging Policy Challenges*, United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) (Jan. 2010), *available at* http: www.unescap.org/tid/artnet/pub/alert5.pdf.

55 Jyoti Bhutani, *FDI outflow of USD 15 billion seen in 2007; Manufacturing to lead the drive- A Report on FDI Outflow and role of manufacturing sector in the Mergers & Acquisitions front*, ASSOCHAM Eco Pulse Analysis, *available at* www.assocham.org/arb/aep/FDI-ouwards.doc.

56 Hereinafter ASSOCHAM.

57 United Nations Conference on Trade and Development (UNCTAD), 'World Investment Report 2011: NonEquity Modes of International Production and Development', United Nations, *available at* http://www.unctad-docs.org/files/UNCTAD-WIR2011-Full-en.pdf.

sufficient experience figures in. In its present form, the CFC law will only serve to throttle the corporate markets in India that has fortunately, been picking up slowly.

C. Impact On The M&A Market In India

It is believed that the "Introduction of CFC regulations would safeguard the interest of the revenue and prevent companies from accumulating profits in low-tax jurisdictions."[58] Corporate leaders have however, raised concerns that the CFC regulations are likely to operate to the detriment of the offshore activities of Indian corporations. Structures such as foreign subsidiaries serve as important means of finance for their Indian parents. With controls on raising capital in India, an ill-developed debt market, excessive reliance on equity financing and full capital account convertibility yet to see the light of the day, income parked in the foreign subsidiaries assumes an even larger role. It is observed that this income primarily finances the transnational merger and acquisition activities of Indian corporations, that are progressively riding up the figures.[59] The argument then follows that if this major source of finance is brutally taxed by the CFC rules, a significant decline in the offshore M&A activities by Indian companies is the natural outcome. Such an eventuality would not only contain the global competitiveness of the Indian corporate sector but their domestic operations are also likely to take a hit.[60] It has been observed in the United States that "Foreign investment that is triggered by foreign economic growth is associated with growing domestic capital accumulation, employment compensation and R & D…"[61]. Though such a survey has been hard to come by in India, it does not preclude the odds that growing foreign activity of Indian companies may result in increased domestic operations too, and the harsh CFC regime in its existent form might grind the grain with the chaff.

D. Reduce Corporate Tax Rate

As law and economics would predict, laws work better when the target group has an incentive to follow the law to its letter. A famous example of the reverse situation is the story of Aditya Birla of the Birla Group who shifted his expansion plans to Thailand and Indonesia owing to the red taped bureaucracy in India.[62] At an abstract level, the

58 Vijay Mathur Report; *supra* note 5.

59 *Deloitte sees Increase in M & A activity in India*, The Economic Times, September 20, 2010, *available at* http://articles.economictimes.indiatimes.com/2010-09-20/news/27600579_1_m-a-activity-cairn-energy-energy-sector; *See India Leads in Merger and Acquisition Deals*, NDTV Profit, August 23, 2010, *available at* http://profit.ndtv.com news/show/india-leads-in-merger-and-acquisition-deals-91165.

60 *See Will CFC Hurt India Inc's M & A Ambitions?* CNBC-TV18, *available at* http://thefirm.moneycontrol.com news_details.php?autono=466428. *See also Raining on India's Parade – What India Can Learn From Brazil About Controlling Capital Flows*, The Economist, October 29, 2009, *available at* http://www.economist.com/node/14753808?story_id=14753808.

61 *See* Mihir A. Desai, et al., *Domestic Effects of the Foreign Activities of U.S. Multinationals*, 1 American Economic Journal: Economic Policy 181 (2009).

62 *See* Gurcharan Das, India Unbound – From Independence to the Global Information Age 179-186. (2002).

CFC regime presents an extremely uncomfortable situation for Indian companies, who not only have to pay tax in the country of residence of the CFC (the low-tax jurisdiction), since the CFC regime takes precedence over any DTAA, but also face exorbitant corporate tax rates in India bordering on 30%, exclusive of surcharge.[63] In order to end deferral and incentivize repatriation of CFC profits, it is essential that the corporate tax rates in India be reduced for such deemed dividends. The Budget 2011-2012 took a positive step in this direction by halving the tax for deemed dividends from 30% to 15%. However, this incentive came packaged with a disincentive that distorts the desirable repatriation scenario. Presently, an Indian company which has incurred debt to invest in the foreign subsidiary can claim expenditure on interest as deduction against the taxable dividend income from such foreign subsidiary. However, the Budget 2011 removed this benefit for no comprehensible reason. There have been no changes regarding the same in the 2012 Budget and there remains a likelihood of increase in administrative costs besides a thwarting of the objectives behind a reduction in tax rate in the first place.[64]

E. Lack Of Foreign Tax Credit Provisions

It is undisputable that the power of taxation is a sovereign power of every state[65], and consequently, nations cannot dictate terms to one another in the framing of tax policy. A DTAA is a double taxation avoidance agreement or treaty between India and another country. Thus, a DTAA is bilateral in nature.

As mentioned earlier, the CFC regime in the DTC will override all DTAAs entered into between India and any other nation. The foreign corporations will be unable to avail of a safety net against double taxation. By superseding the DTAAs, the CFC rules allow the Indian government to unilaterally terminate a DTAA. These rules also allow a potential for double taxation to operate and thwart, if not paralyse, the functioning of the CFCs. In effect, the CFC rules foster the possibility of disturbing the international comity that the DTTAs sought to achieve.[66]

Assuming but not conceding that the CFC rules are the need of the hour in India, it is suggested that a system of foreign tax credits be put in place to cushion CFCs against the likelihood of double taxation. This is a how a tax credit would work: suppose company X is controlled from India and is a resident of country Y, a low tax jurisdiction. Its tax liability on its income in country Y is $100,000. Its tax liability on its 'deemed dividends' according to the CFC regime is $250,000, assuming Indian corporate tax rate

63 The corporate tax rate in Budget 2012 remains at 30% for domestic companies and 40% for foreign companies. The surcharge on income tax for companies with total income exceeding INR 10 million also remains at 5% for domestic companies and 2% for foreign companies.

64 The International Tax Team of Nishith Desai Associates, *India Budget Insights 2011-12*, *available at* http://www.indialawjournal.com/volume4/issue_1/india_budget.html.

65 Amrit Banaspati Co. Ltd. v State of Punjab, (1992) 2 SCC 411.

66 The magnitude of the problem is substantial as India has entered into DTAAs with 82 countries.

is higher than the rate in country Y. In the absence of a foreign tax credit provision, company X will have to shell out $100,000 in tax liability to country Y and $250,000 in tax liability to India. Its total tax liability for any financial year thus stands at $350,000. However, if tax paid by company X was allowed to be credited in India, in case of a full credit, company X pays only $150,000 ($250,000 - $100,000 [already paid to country Y]) as tax to India. The total tax liability of X would thus stand at $250,000, a full $100,000 less than if such tax was not allowed to be credited.

Such credits have been used in several jurisdictions to tackle the problem of double taxation.[67] Moreover, India can tweak the tax credit regime to suit its policy. This means that a choice is available from an array of systems of foreign tax credits that presently exist.

Foreign tax credits have often been criticized as forming an extremely complex set of rules, hard to administer and implement.[68] However, denying foreign tax credits "seems unduly to elevate simplicity over fairness."[69] The CFC rules, as proposed in the DTC, amount to what has been called confiscatory taxation[70], over-taxation and double taxation, and hence must be redeemed by the introduction of a foreign tax credit system.

Further, tax credit should also be allowed when the dividends, which have already been taxed under the CFC regime, are later actually paid to the resident Indian company.[71]

V. Effect Of The New Test For Residential Status Of A Company

Clause 4(3) of the DTC now provides that a company shall be considered to be an Indian resident if the place of its *effective management*, at any time in the financial year, is located in India.[72] Under Section 6 of the Income Tax Act, 1961, which is presently in force, a company is to be considered a resident in India if in the previous year, the *control and management* of its affairs is *wholly* situated in India. While an evaluation of the true import of the above clause is subject to judicial pronouncement,[73] it would not be unreasonable to assume that at least in some cases, *effective management* would be the same as *control and management* and in such cases; a CFC will be treated as an Indian company under the DTC. Needless to say, in that event, the CFC rules will lose their effect.

---

67 Glenn E. Coven, *International Comity and the Foreign Tax Credit: Crediting Non-Conforming Taxes*, 4 Fla. Tax Rev. 2, 84 (1999).

68 Charles I. Kingson, *The Foreign Tax Credit and its Critics*, 9 Am. J. Tax Pol'y 1 (1991).

69 John P. Staines, Jr., *Whether, When and How to Tax the Profits of Controlled Foreign Corporations*, in the *Symposium on International Tax Policy in the New Millennium, Panel III: U.S. Multinational and International Competitiveness*, 26 Brook.J. Int'l L. 1595 (2001).

70 Conversation with Manmohan Singh in V.N. Balasubramanyam, Conversations With Indian Economists 85 (2001).

71 See the OECD, Model Tax Convention on Income and Capital, Commentary on Article 10, ¶ 39.

72 The twofold test for determining the place of effective management is:
i. The place where decisions are madebythe executive directors or board of directors of the company. or
ii.The place where the board of directors routinely approve the commercial and strategic decisions which are made by the executive directors or office of the company. The Standing Committee on Finance has

VI. Applicability Of The GAAR

At this point, it is also expedient to note the interactions between the CFC regime and the General Anti-Avoidance Rule[74] which has been widely and most recently debated for its draconian measures. The GAAR codifies the rule of 'substance over form' which, for the determination of tax liability, accords significance to real intention of the parties to a transaction, effect of the transaction and the purpose of the arrangement rather than the sophisticated legal structure set up by the parties. Thus, 'impermissible avoidance arrangement'(s) which lack any commercial character and are entered into mainly for the purpose of obtaining tax benefits are hit by the GAAR. The GAAR thus incorporate provisions similar to the motive test as elaborated in the *Cadbury Schweppes* case. After the latest amendment in the Finance Bill 2012[75], the GAAR enjoys a limited override of the DTAAs except in cases of indirect transfers.[76] The burden of proof has been shifted back to the Revenue Department.[77] As a part of its most controversial and draconian feature, when a structure has been determined to be an 'impermissible avoidance arrangement', the GAAR grants wide discretionary powers to the tax authorities to re-characterize debt as equity and capital as revenue, relocate the place of residence of a party, the location of a transaction, and the situs of an asset to a place other than that provided in the arrangement, in addition to reallocating expenses and incomes between parties to a transaction.[78] The GAAR provisions are in addition to and in conjunction with other anti-avoidance measures that determine tax liability. Thus, it cannot be ruled out that both the CFC rules and the GAAR will become applicable to a CFC after the DTC is in force. That would be a double blow to the expansion plans of Indian companies and Indian businesses in general as they would be subject not only to an incomplete CFC regime but also to the vagaries of the tax authorities under the GAAR.

VIII. Role Of The Judiciary

As an expected consequence of the half-hearted attempt of the legislature in introducing the CFC regime, several provisions in the rules are vague and find no clarity

highlighted the problems assosicated with the 'place of effective management' test for determining the residence of a body corporate. One of the problems is that the above test does not take into account the decisions made by Independent Directors of a company. See Recommendations of the Standing Committee on Finance on the Direct Taxes Code Bill, 2010 (March 17, 2012) Nishith Desai Associates *available at* http://www.nishithdesai.com/Budget2012/Standing%20Committee%20Recommendations_Hotline.htm.

73 The concept of 'control and management' has been the subject of controversy in the Indian judiciary. *See* CIT v. Bank of China (in Liquidation), [1985] 23 Taxman 46 (Cal.), Narottam & Pereira Ltd. v CIT, [1953] 23 ITR 454 (Bom.).

74 Hereinafter GAAR.

75 The amendment was made on May 7, 2012. The implementation of the GAAR has been deferred to April 2013.

76 Nishith Desai Associates, *Antidote for Panic: FM Announces Delay of GAAR* (May 14, 2012), *available at* http://www.nishithdesai.com/New_Hotline/Tax/TAX%20HOTLINE_May1412.htm#b%23b.

77 *See Memorandum to the Finance Bill 2012: Provisions Relating to Direct Taxes, available at* http://indiabudget.nic.in/memo.asp.

78 *See Memorandum to the Finance Bill 2012: Provisions Relating to Direct Taxes*, http://indiabudget.nic.in/memo.asp.

within the DTC. For instance, expressions such as 'collective' exercise of influence, exercise influence so as to assert 'decisive influence', 'indirect' entitlement to shares, 'direct' and 'indirect' holding, and 'routinely' in the place of the effective management test have no explanations leaving the taxpayer uncertain about his tax liabilities. Adam Smith would not be the least bit happy about this obvious violation of the Canon of Certainty.[79] Further, the CFC regime only excludes a corporation carrying on active trade or business from the definition of a 'controlled foreign corporation' but does not recognize the international practice of excluding passive incomes derived from the active conduct of a trade or business such as transactions in insurance, banking, finance or incomes derived from certain securities transactions. The above coupled with the lack of foreign tax credits indicates that the CFC rules in the DTC come with insufficient exemptions, contrary to the established practice in jurisdictions such as the UK, Japan and even South Africa.[80]

A. The Motive Test

Another bone of contention with respect to the CFC rules is the motive test. In the UK, the matter of *Cadbury Schweppes plc & Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [Cadbury Scweppes case] is an important ruling by the Grand Chamber of the European Court of Justice [ECJ]. The Cadbury Schweppes group established two subsidiaries in Dublin, Ireland in order to avail of the low tax rate regime [10% corporate tax rate as opposed to more than double that rate in the UK] in relation to profits from internal financing activities. When UK authorities demanded corporate tax, Cadbury Schweppes appealed to the ECJ. The Court ruled that "…the CFC rules could be justified where they were designed to restrict wholly artificial arrangements intended to escape the national tax normally payable".[81] Whether a CFC is a 'wholly artificial arrangement' is a determination based on objective factors. If a CFC was established or incorporated with the sole purpose of arbitraging tax laws among the Member States in the European Union, carries out no other economically productive activities and has no commercial presence otherwise, the CFC must be judged to be a 'wholly artificial arrangement'. However, CFC rules are not attracted where a CFC, active in its commercial sphere and carrying on genuine economic activities, seeks to take advantage of favourable tax regimes. Freedom of establishment[82] cannot be said to have been abused in such cases. Further, the Court ruled that CFC rules are also not attracted where a CFC satisfies the motive test according to which the parent resident UK company must show that reduction in tax by diversion of profits to the CFC or exploiting opportunities of

79 *See* Charles F. Bastable, *Canons of Taxation*, *in* Public Finance (1892), The Online Library of Liberty, *available at* http://oll.libertyfund.or?option=com_staticxt&staticfile=show.php%3Ftitle=275&chapter=35256&lay out =html&It emid=27.

80 Nishith Desai Associates, DTC Global Think Tank, *supra* note 53.

81 Cadbury Schweppes case, *supra* note 50.

reduction in tax liability by resorting to low tax rate regimes was not the main reason for the incorporation of the CFC [thus bringing 'wholly artificial arrangements' within the purview of the CFC rules]. Later, the ECJ delivered a reasoned order[83] in *CFC GLO (C-201/05)* placing the burden of proof on the resident UK company to establish that it has not entered into a wholly artificial arrangement to avoid tax and that its activities in the foreign jurisdiction reflect economic reality or in other words, it carries on 'genuine economic activity' in the other Member State.[84] The Court of Appeal issued a similar ruling in *Vodafone 2 v HMRC*[85] noting that the new exception of 'genuine economic activity' could be read into the UK CFC rules. The concept of 'genuine economic activity', however, remains without sufficient elaboration.

The situation in the USA seems even more uncertain. The present CFC regime is vaguely worded and is subject to wide interpretations by the tax authorities. The US courts have been alternating between objective and subjective factors or a combination of both to determine if a transaction lacked economic substance and was a sham, and thus have failed to provide an encompassing legal standard.[86] More recently, in *Merck & Co. Inc. v United States*,[87] the Third Circuit Court merely applied the substance over form doctrine and did not consider it necessary to examine the economic substance of the transaction.

In the CFC regime incorporated under the DTC, the 'active trade or business' requirement comes closest to the motive test used by the courts in the UK and the US. The import of the phrase 'active trade or business' is only illustratively explained, and hence, the Indian courts will have to assume the responsibility of interpreting this (and many others outlined above) phrase on a transaction-by-transaction basis and suitably follow or reject the motive test as outlined by the practices of the courts in other jurisdictions. In the face of an incomplete legislation, an active role will have to be assumed by the Indian judiciary.

IX. Conclusion

This paper has attempted to understand and comment upon the probable impacts of the new CFC Rules under the Indian DTC, awaiting enforcement. Without a sufficiently

82 Treaty Establishing the European Community [TEC], Article 43, 48.

83 Reasoned orders are issued in place of a judgment when the Court has already ruled on an identical question.

84 *See* Tom O'Shea, *ECJ Clarifies Issues Raised in Connection with U.K. Dividend Tax, CFC Rules*, May 20, 2008, *available at* http://www.ccls.qmul.ac.uk/docs/staff/oshea/52231.pdf.

85 [2009] STC 1480 (CA).

86 *See* David Myers, *supra* note 30 citing Packard v Commissioner 85 T.C. 397 (1985) [subjective factors in determining the taxpayer's motive]; Rose v Commissioner, 88 T.C. 386 (1987) [combination of both subjective and objective factors used].

87 No. 10–2775. 2011.

detailed study and data analysis, it is almost impossible to conclude whether or not India can do without a CFC regime. Yet, an alternative to the CFC regime might be a framework where it can be made mandatory for Indian shareholders (and controllers) of a CFC, to include in their taxable income, the income that has attributed to them by virtue of their shareholding in such foreign corporation, but has not been distributed as dividends. A similar framework exists in the US Passive Foreign Investment Company Rules. It is also worthy of note here that such a regime would in effect, bear the same outcome as the imputation system for active income discussed earlier. The law would thus, play a role not at the frontier but from the barracks and would shift the cost of the undistributed dividends on to the shareholders rather than the CFC. This shift is likely to push the shareholders towards the receiving end of the law and would thus, provide them with an incentive to take necessary internal actions to minimize or eliminate this new cost by inducing the CFC to repatriate its profits to India.

It is essential to realize the distinction between an economy that has upgraded to making outbound investments on a large scale and an economy that is only slowly but progressively increasing outbound investments. It is urged that the Indian legislators must study the market pattern for a few years to get a good grip over the facts. They will then be in a better position to determine whether CFC rules are required in India in the first place.[88] This strategy is better than unleashing a badly written law and then making regular amendments to it, through infinite circulars and notifications as the Central Board of Direct Taxes[89] is wont to do, as more facts reveal themselves. Without fact-based evidence, the CFC rules are at best, a premature attempt to tackle a problem of whose existence one isn't even sure of.

On the other hand, irrespective of whether the CFC rules are intended to be introduced as a measure of abundant caution or whether India is in a hurry to match up its tax policy to international practice, the task must not be left incomplete at the very first stage. Foreign tax credits have been unexplainably left out of the CFC regime and must be included at the earliest. The international scenario supports this suggestion too. The content and structure of the tax credit apparatus is best left to the Indian policy makers and is beyond the scope of this paper. However, the absence of such tax credits altogether from the framework of the law is an uncomfortable, even an unjust situation for the taxpayers and flies in the face of one of the sacred canons of taxation, i.e. convenience.[90] Additionally, provisions that can cushion the Indian companies against the hard strike of the CFC law, merit consideration. Such provisions can include brief exemptions for certain intra-group activities,[91] for instance, an acceptable distribution range of profits where the foreign corporation would be exempt from CFC rules if it distributes 80% of profits in 2 years; and *sui generis* mechanisms.

88 Declan Gavin, *supra* note 19.

89 CBDT is the Indian Government body that monitors and regulates the collection of direct taxes in India.

At this point, the words of the famous economist John Maynard Keynes in the context of the National Industrial Recovery Act[92] seem rather well placed:

"The Act is on the Statute Book; a considerable amount has been done towards implementing it; but *it might be better for the present to allow experience to accumulate before trying to force through all its details*. That is my first reflection—that (N.I.R.A., which is essentially Reform and probably impedes Recovery), *has been put across too hastily*, in the false guise of being part of the technique of (Recovery) [added emphasis]."[93]

90 Adam Smith, An Inquiry Into the Nature and Causes of the Wealth of Nations, (1776).

91 As is to be incorporated in the UK CFC law discussed earlier.

92 Act of June 16, 1933 (Ch. 90, 48 Stat. 195, formerly codified at 15 U.S.C. sec. 703). This legislation established a national public works program and authorized the US President to regulate industry, permit cartels and monopolies. The legislation sought to stimulate economic recovery in the aftermath of the Great Depression.

93 John Maynard Keynes, *An Open Letter to President Roosevelt*, *available at* http://newdeal.feri.org/misc/keynes2.htm

The Vodafone Saga: Tax Planning And Corporate Veil Piercing

*Nishant Sharma**

Abstract

Corporate veil piercing in taxation matters had until recently been a well-defined subject with settled judicial precedents. A fine line had been struck between the need to tax transactions while still allowing scope for tax planning. This said distinction was based, *inter alia*, on the meaning of 'colorable device'. However, the Vodafone Judgment in 2009 completely changed the scope of standards by expanding them further without, as some suggest- proper justification. The matter was placed before the Supreme Court, which came out with its judgment earlier this year, restoring clarity to the basic principles of tax jurisprudence that had been arrived at after years of litigation. While the decision in favor of Vodafone has come as a welcome relief to many, it is also interesting to note that there are other similar transactions in the offing and thus the *Vodafone* case has wider ramifications. Furthermore, with the Government not ready to let the Vodafone deal pass by, this controversy still remains alive after years of litigation and adjudication by the highest judicial authority of the country. This paper, analyzes the judicial developments as a result of the case along with set precedents on corporate tax planning in other common law jurisdictions such as Canada and the United Kingdom. The author thus tries to ascertain the changing contours of the Indian investment climate and its implications for the near future.

Introduction

Tax reduction is not evil if you do not do it evilly.

- Murphy Logging Co. v. United States[1]

One of the basic characteristics of a corporate entity is its separate legal identity. It is one of the most recognized concepts in corporate law across several jurisdictions. Especially in common law countries, as witnessed in the case of *Solomon v. Solomon*[2] as well as other cases under the Indian[3] and even in the US[4] jurisdictions, the corporate personality is usually upheld and courts refrain from interfering. However, in certain cases, the court may look beyond the legal fiction involved, and into the reality or the root of the matter.[5] The corporate veil may be pierced in matters where there has been

* IV Year, B.Com. LL.B. (Hons.), Gujarat National Law University, Gandhinagar.

1 Murphy Logging Co. v. United States, 378 F.2d 222 (1967).

2 [1897] AC 22 (HL). Also see, generally Lee v Lee's Air Farming Ltd [1961] AC 12 (PC).

3 Meenakshi Mills, Madurai v. The Commissioner of Income Tax, Madras, AIR 1957 SC 49.

4 Berkey v. Third Avenue Railway, 244 N.Y. 602, 155 N.E. 914 (1927).

5 3 N. Vijia Kumar, *Income from Other Sources, Lifting of Veil and Section 57 (iii) of the Income Tax Act, 1961*, 199 TAXMAN 12 (MAG) (2011).

under utilization of capital, or failure to fulfill corporate formalities, frauds, alter ego etc.[6] In addition, where the willful conduct of the directors etc. itself causes for the corporate veil to be pierced in instances where their actions are *mala fide* on the face of it.

Being one of the most litigated issues in corporate law in different jurisdictions, and with the *Vodafone* case having just reached its conclusion, it becomes imperative to look at the present legal position on this subject. One is compelled to question as to whether the nexus of a transaction with India, even if the nexus is only in the form of the assets beings located in India is in itself reason enough to pierce the corporate veil in order to look into the intention of the parties. With other such deals also having been completed either prior to or at the same time as the Vodafone deal, the whole corporate world is following the implications of the judgment very closely. With the Finance Bill having received the presidential assent, new aspects of the problem have now emerged. The retrospective amendments to definitions under Section 2 and Section 9 of the Income Tax Act, 1961 not only make sure that any deals à la Vodafone entered into from now would fall under the tax net, but also keeping in mind the statements made by the Finance Minister in his Budget speech, could also pose problems to Vodafone as well. Thus, the Vodafone affair continues to be the controversy that refuses to die down.

This paper while beginning with a discussion on the general principles of corporate veil piercing with reference to tax planning contradistinguishes the same in other common law jurisdictions of the United Kingdom and Canada before entering into the development of the Vodafone controversy, as we know it today. The author, while giving a brief idea of what panned out before the High Court, focuses more on the Supreme Court decisions and the ramifications that the budget could have on deals such as Vodafone, and more importantly, the economy of the country itself. One must make sure that by trying to stop India from being perceived as a tax haven, it should not become overtly excessive, when it comes to exercising its tax jurisdiction. For the same to happen, the controversy needs to bury itself, but with the recent renewed efforts by the Government, the same does not seem to be happening in the near future. With the Direct Taxs Code[7] perpetually changing form even before implementation and with new changes being suggested perennially, the author would not delve into the subject of how the judgment would stand under the DTC.

I. Corporate Veil Piercing: The Position in Other Jurisdictions

Against the general rule and legal fiction of separate legal personality, sometimes, especially in cases of fraud and tax evasion, the corporate veil is pierced, and those behind the subject matter of the transaction are held responsible. Corporate veil piercing is no longer restricted to a few jurisdictions. Yet, as is usually the case with power, it must

6 CIT V. Associate Clothiers Ltd. AIR 1963 Cal. 629; Juggilal Kamlapat v. CIT, AIR 1969 SC 932.

7 Hereinafter DTC.

be used responsibly and thus veil piercing must not be done indiscriminately. Nevertheless, the 2008 version of OECD Model Convention commentary also specifically acknowledges that the purpose of tax conventions, inter alia, is to prevent tax avoidance and evasion. This is seen as one of the main reasons for veil piercing. In other common law jurisdictions such as Canada and the United Kingdom's, similar parameters for veil piercing such as ours are followed. Let us have a brief perusal of the same:

A. Canada

In tax matters, in addition to being granted the status of a taxpayer, a corporation derives several advantages from its being so. But where such an advantage persists, there also exists scope for abuse. Hence, the legislators and courts have developed various techniques to "pierce the corporate veil", so that in certain matters, the shareholders, officers and/or directors may be jointly held or severally liable for the obligations of the corporation. The Supreme Court of Canada in *OPSEU v. Ontario (Attorney General)*[8] while stating that the case of *Solomon v. Solomon*[9] had become a major part of their law, also stated that in certain cases the veil can be lifted in the interest of third parties. Though there have been contradictions to the same, the Civil Code of Quebec Art. 317 specifically provides for no defense of juridical personality in matters where it [Corporation] is being set up solely for the purpose of dissembling fraud or abuse of rights or contravention of a rule of public order etc.

Thus, this section is a codification of the fact that there can be a transgression on the immunity that has been given to corporation in this regard. But, the three main elements evidenced through case laws that are being used to constitute the basis for the piercing of the corporate veil are:

1. The shareholders must themselves be involved in the transaction at issue;
2. They must have acted in bad faith when the transaction was entered into; and
3. The transaction entered into in bad faith by the shareholders must have the effect of confusing (in a tacit or explicit manner) the patrimony of the shareholders with that of the corporation, and thus of contravening the principle of patrimonial division.

The courts have applied such principles for veil piercing in landmark cases relating to tax such as *Toronto (City) v Famous Players Canadian Corp*[10] and *Aluminum Co of Canada v Toronto (City)*.[11] While the former related to the inclusion of the income of the subsidiary into the income of the parent for taxation purposes, the latter applied the ruling of the former wherein it was stated that "in a way the subsidiary was a puppet in the hands of

8 [1987] 1 SCR 2, at 26.
9 *Supra* note 2.
10 [1936] 2 DLR 129 (SC).
11 [1944] 3 DLR 609 (SC).

the parent company as it had no independent functioning of its own."

These ruling were further applied to cases such as *Conseil de la Santé (Montréal) v. City of Montréal*[12] and *Smith, Stone & Knight and Aluminum Co.*[13] However, this test has proved to be very stringent as for it to take place there needs to be no independent functioning of the subsidiary. However, these cases are now considered the exception to the general rule; the basic rule remains that taxation is by itself very burdensome on the individuals and corporations[14] and veil piercing for taxation purposes is to be applied in exceptional circumstances only.

One of the main reasons to justify infringement on the legal personality of the corporation in relation to taxation is *via* fraud. Nevertheless, the mere using of a corporation for reduction of tax liability is not the sole reason for piercing of the corporate veil.[15] Instead, there should be a convincing proof of fraud. It is true that the controlling shareholder must structure a false transaction or some other actions with the specific intention of committing fraud. Thus, chiefly two situations may arise where fraud can lead to piercing of the corporate veil:

> *On the one hand if a company is formed for the purpose of evading legal obligations or concealing fraud, the court will look behind the corporate veil.[On the other hand] if, after incorporation, those in control of the company direct it to commit a wrong, courts can pierce the veil.*[16]

Thus, in both the situations, a person who knowingly uses the company's separate legal identity as a means to commit fraud is not protected on that count.

B. United Kingdom

In the UK, a landmark judgment on similar issues was propounded back in 1936, in *IRC v. Duke of Westminster*[17], wherein it was stated that "given a document of transaction is genuine the court cannot go behind it to some supposed underlying substance." The above rulings being applied in Canada that talk about extensive control have not been applied strictly in the United Kingdom. In *Adams v Cape Industries PLC*, [18] the Court refused to pierce the veil even though it was proven that the parent company exercised considerable control over the subsidiary. According to them, true veil piercing can only occur in matters where the company has been set up for fraudulent purposes and thus

12 [1994] 3 SCR 29.
13 [1939] 4 All ER 116 (KB).
14 Inland Revenue Commissioners v. Westminster (Duke), [1936] AC 1 (H.L.).
15 R. v. Keylsen, 96 DTC 6265 (Man. QB).
16 Howard J. Kellough and Peter E. McQuillan, Taxation of Private Corporations and Their Shareholders 245, (3d ed. 1999).
17 [1936] AC 1, at 19-20 (HL).
18 [1990] Ch 433 (CA).

did not envisage other situations where the same can be put to use. Under UK Law, veil piercing is seldom done. The Adams case also rejected the single economic unit theory propounded by Lord Denning in the matter of *DNH Food Distributors v. Tower Hamlets*.[19]

Lifting of corporate veil is definitely recognized under English Law,[20] however it is rarely used. It is another recognized principle in the United Kingdom, that justice alone would not warrant lifting of the corporate veil and unless there is a clear intent of mala fide included, the court will not employ equitable discretion.[21] Fraud has thus been recognized through many judicial precedents as a legitimate ground for invoking this doctrine.[22]

Thus, while there have been certain variations in piercing of the veil, the basic principle still remains that if a transaction is genuine, the court should not interfere. The court should look at the form and not the substance, as focus on the latter would not only be onerous to the court but the organizations as well. However, in cases of fraud etc., the substance of the transaction can be looked into.

II. The Position in India

A company, as stated before is capable of enjoying rights and duties that are different from its members due to it being an artificial person having a separate legal identity.[23] It has a separate personality and identity from that of its shareholders.[24] This separation is qualified in nature i.e. in certain conditions such as when it is used for unjust and inequitable purposes, and then this veil is lifted. [25] These qualifications are in other words an exception to the general rule, the general rule being that of separate legal personality. These exceptions also include tax evasion and circumvention of tax obligations.[26]

Tax planning is permissible as seen by the fact that companies routinely chose to follow the path of routing investments through Mauritius or the Cayman islands solely for the benefits, tax or otherwise that accrue out of such transactions. Furthermore, until glaring loopholes in our Double Tax Avoidance Agreements with Mauritius that allow for capital gains to not be taxed at all are removed, the revenue department cannot expect the courts to decide against what is clearly the letter of the Law. Thus, evidently,

---

19 [1976] 1 WLR 852 (CA).

20 Creasey v. Breachwood, [1993] BCLC 480 (CA) though later overruled by Ord v Belhaven Pubs Ltd [1998] 2 BCLC 447 (CA).

21 Trustor v. Smallbone. [2001] 2 BCLC 436 (Ch. D.).

22 Jones v. Lipman, [1962] 1 WLR 832 (HC); Gilford Motor Co. Ltd. V. Home. [1933] Ch. 936 (CA).

23 Paul L. Davies, Gower And Davies, Principles Of Modern Company Law 22 (8th ed., 2008).

24 Salomon v. A Salomon & Co. Ltd., [1897] AC 22 (HL); Guzdar v. CIT, AIR 1955 SC 74.

25 Karen Vaderkerchkove, Piercing The Corporate Veil 249 (2007).

26 C.I.T., Madras v. Meenakshi Mills Ltd., (1967) 63 ITR 609 (SC).

courts in India have also upheld tax planning as a legitimate practice. However, the planning should not form a colorable device. What this means is that it should not have been used specifically as a means to evade tax. So if one manages to order their affairs in a manner, which enables them to pay a lesser tax under the appropriate act than they otherwise would have, then they cannot be compelled to pay more than that amount.[27]

Thus, if an entity is made solely as a facade for the purpose of evading taxes, then it cannot be held to be a separate entity as such.[28] Thus, the form of the transaction may be ignored, if its substance evidences the use of a colorable device.[29] As a corollary to the same, if the transaction is plain and unambiguous, then the form and not the substance should be looked into.[30]

The landmark case of *McDowell v. CTO*[31], laid down the basic framework at the time on the issue of tax planning. In this matter, Justice Rangnath Mishra had observed that:

> *Tax planning may be legitimate provided it is within the framework of law, colorable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honorable to avoid payment of tax by resorting to dubious methods.*

For example, one may cause income to be diverted before it accrues to him, thus exempting himself from tax on that amount. These devices, as stated by the Court do not depend upon considerations of morality.[32] This has been reiterated by the Supreme Court in later decisions as well.[33] Thus the *McDowell v. CTO* case was nothing more than an exception to the hitherto settled law which allowed for tax planning. This jurisprudence was furthered in the matter of *Shiv Kant Jha v. Union of India*.[34] tax planning was deemed permissible in later cases such as *Commissioner of Income Tax v. Punjab State Electricity Board*.[35] Thus, even the courts have specifically upheld tax planning as legitimate, unless of course the same can be shown to be a colorable device. Hence, tax planning finds itself in relation to economic planning, and while the latter is for the state the former is for the subject.[36] It would not serve the economy well to tax the ingenuity of the individual in understanding the complicated maze of tax laws and positioning themselves in a manner to incur the least tax burden and hence benefit most out of their income. Therefore, if

27 *Supra* note 13.

28 Barber-Greene Americas Inc. v. Commissioner of Internal Revenue, (1960) 35 TC 36, Union of India v. Azadi Bachao Andolan, (2003) 263 ITR 707 (SC).

29 *Id.*

30 CWT v. Arvind Narottam, (1988) 173 ITR 479 (SC).

31 AIR 1986 SC 649.

32 Madhuram Agarwal v. State of Madhya Pradesh (1999) 8 SCC 667.

33 *Supra* note 27.

34 Review Petition (Civil) No. 1917-1918/2003 & Curative Petition No. 10569/2004.

35 1980 124 ITR 894 (P.H.).

36 Institute of Chartered Accountants in India, Direct Tax Laws, Volume I, 14.1.

tax planning not involving colorable devices is legitimate in its nature, its denial to an individual refuses to make economic or legal sense.

III. Vodafone Decision and Tax Planning

Vodafone International Holdings BV v. Union of India[37] involved four major players. Hutchinson International[38] (non-resident company) held 100 percent shares in CGP Investment Holdings Ltd (non-resident company registered in the Cayman Islands) which in turn held 67 percent shares in Hutchison Essar (Indian company). Vodafone International, another non-resident company acquired, the entire shareholding of CGP Investments, thus indirectly also acquiring 67 percent share in Hutchinson Essar. Thus not only were the buyer and the seller, positioned outside India, the transfer itself took place beyond the territory of India, and the only connection of the entire transaction to India was the indirect transfer of Hutchinson Essar whose assets were situated in India.

The basic question arose whether the income has accrued or has arisen in India under Section 9 of the Income Tax Act. The Income Tax Department (of the view that it does), issued Vodafone a show cause notice asking why no action should be taken against Vodafone under the Act for not deducting tax at source while making payments to Hutch and thereby sought to recover USD 2.1 billion from Vodafone as alleged withholding liability. Its validity was challenged before High Court which stated that the petition challenging the show cause notice was premature as there was an alternative remedy available to the petitioner. The Supreme Court also dismissed the same with the direction to re-agitate the issue of jurisdiction with the concerned Assessing Officer.[39]

The High Court, in its endeavor to decide on the validity of the show cause notice, inadvertently answered all the other issues against Vodafone, without really providing final and concrete conclusions. Thus, the judgment was understood to exist more for the academic interests rather than for conclusive determination. The High Court in this matter, tried to lift the veil over the intermediary by reasoning that the transfer of the intermediary in effect led to the transfer of a controlling stake in Hutchison Essar, which was the only Indian company involved. Even though the Additional Solicitor General on behalf of the state categorically stated that they did not believe the said transaction to be an illegal act or a colorable device, the Court decided the case as a fit one to pierce the veil, thus making the exception to the general rule. Thus, not only was the requirement of the transaction being structured as a colorable device not fulfilled, the judicial precedents over the years that had come to settle the principles of when piercing can occur were also largely ignored. Therefore, if such reasoning was to be accepted by the courts in India, then the same would be on faulty ground and would seriously jeopardize

37 [2009] 311 ITR 46 (Bom).

38 Hereinafter HTIL.

39 Vodafone International Holdings BV v. Union of India, [2009] 179 TAXMAN (Bom).

other mergers and acquisitions that had happened around the same time, as notices had been sent to others as well, along with the fact that companies would be wary of the tumultuous conditions in the market and would put their future investment plans on hold.

In the same year as the Vodafone Judgment, there also existed the *E*Trade Mauritius case*,[40] where the Advance Ruling Authority had given a different opinion on similar facts and circumstances. The facts in this matter involved a Mauritian Company, which was a subsidiary of a US Company. The subsidiary received capital contribution and loans from the parent and bought shares in ILFS, an Indian company. When these shares were subsequently sold, capital gains accrued in favor of the applicant (the Mauritian Company), which were exempt from tax under Article 13(4) of the Indo Mauritian Direct Tax Avoidance Agreement. According to the Income Tax Department, the company in Mauritius was only a facade and its sole purpose was to avoid taxes that would otherwise be incident on the US Company. The Court rejected this contention and held there to be no legal taboo against treaty shopping. It held that if an entity, for the purpose of mitigating its tax liability sets up another entity in a tax friendly zone, then the conduit entity cannot be simply declared invalid. It also opined that the Court, as stated before should not look into the matter or substance to judge validity or legality transaction. Instead, if less than honest means are applied by parties to escape tax liability, then the same is to be covered within the ambit of circumstances when the veil can be pierced. Where the documents themselves are a sham and only used to cover up the real transaction, only then would the circumstance be apt for veil piercing. Sham transactions are one where legal rights and obligations are only for the purpose of fooling the regulatory authorities involved; and even when the parties do not intend to have legal obligations, but do so only to portray the same to third parties, it would be a fit case to be called as a sham transaction. Thus if all the legal formalities are completed, there is no reason to consider the transaction as a sham. In the absence of compelling reasons, there is no reason to even consider piercing the corporate veil, let alone actually undertake the act.

IV. Why the Reasoning Behind the Vodafone [HC] Decision Cannot be Deemed Correct in Law

The revenue department stated that the transaction of the petitioner amounted to a transfer of the capital asset situated in India and not merely "*transfer simplicitor*" of controlling interest *ipso facto* in a corporate entity. The Court felt it was inconceivable how Hutchinson could transfer its controlling interest in Hutchinson Essar without extinguishing its right in the shares of the Indian group. Further, the Court concluded that the purpose of transfer was to acquire controlling interest in Hutchinson Essar. The Court felt that the shares were merely a mode or a vehicle to transfer some other assets. This "other asset" was deemed to be situated in India. In addition, referring to CGP and HTIL as

40 A.A.R. No.826 of 2009.

similar entities or part of group companies is akin to lifting corporate veil between the entities of the same group, which is not in accordance with common law doctrine on group companies.[41] Similarly, considering both to be the same is rife with inadequacies as then a company can hold just 49.9 percent stake with no chargeability to tax.[42]

The Court instead of bringing forth an in-depth analysis of the merits should have just stated that the notice was not *non est* in law and thus could be maintained on that ground. The Court eventually stated that the transfer of capital asset situated in India and the capital gains arising therefrom is chargeable under Section 9(1) (i) of the Income Tax Act. As seen in *Gulzar v. CIT*,[43] nothing under Indian law fuels the assumption that the shareholder has any interest in the property of the company. In *Carrasco Investments v. Special Director, Enforcement Directorate*,[44] the Court refused to categorize the sale of the shares of a parent company outside India as a sale of shares of the subsidiary company within India.[45] The only exception to this would be if the corporate veil were lifted over the intermediate company. However, the facts in the Vodafone case do not warrant the same.[46] The existence of group companies or fully owned subsidiary itself would not entitle piercing of the corporate veil.[47] The doctrine of looking at the substance and not the form of the transaction applies when there is a colorable or illegal transaction, which has to be ignored. Thus in other circumstances, the substance should be ignored and only the form looked at. Further, subsequent transactions cannot be looked into in order to envision the prior transaction in a different light. Thus, the Court, though correct in maintaining the validity of the show cause notice, seemed to fault when it came to the merits of the dispute by overlooking judicial precedents, legal principles and adequate reasoning to the contrary.

By such a ruling, India may actually have added more complication to its existing taxation structure.[48] The Court chose its reasoning knowing that, a controlling interest alone under the Act does not constitute a separate or distinct capital asset.[49] So, even for composite consideration, there should be distinct assets.[50]

---

41 *Supra* note 17.

42 T.N. Pandey, *Bombay High Court's decision concerning tax deduction at source where transacting parties are non-residents*, International Taxation, [2009] 176 TAXMAN 65(MAG).

43 1986 SCR (1) 164.

44 [1992] 2 Comp LJ 339 (Del.).

45 *Bombay HC Vodafone decision, Some Insights, available at* http://legaldevelopments.blogspot.com/2008/12/bombay-hcvodafone-decision-some.html.

46 *Supra* note 17.

47 In Re Acer Computers, (2004) 189 CTR 498 (AAR).

48 Rano Jain, *An Analysis of Bombay High Court's Decision in Vodafone Case*, International Taxation, [2009] 176 TAXMAN 75 (MAG).

49 Baijnath Chaturbhuj v. CIT [1957] 31 ITR 643 (Bom.).

50 R.P. Garg, *Bombay High Court on Vodafone, International Taxation*, [2011] 198 TAXMAN 12 (MAG).

Further in *Carew and Co. Ltd v. Union of India*,[51] it had been stated that by way of acquisition of all the shares of a company, the shareholder could only acquire control and the right to manage and would not as a result acquire the undertaking. Further, the words "directly and indirectly" under Section 9 (1) (i) appear before "accruing and arising", so the same interpretation cannot be given to "transfer' under this sub-section.[52]

V. Analysis of the Vodafone Case: Supreme Court

The difference between tax avoidance and tax evasion is the thickness of a prison wall.

- Denis Healey

The culmination of the dispute on the 20th of January this year in favor of Vodafone in the multi-billion dollar dispute has caused a ripple of the favorable kind in the international market. The Court has brought back clarity to the issue of cross border investment after years of turbulence. The Revenue department, *inter alia* contended that the capital gains arising out of the transaction as a result of transferring the shareholding of CGP would amount to transfer of a capital asset situated in India and hence it would be liable to tax. The Supreme Court, while rejecting the above contention held that no part of the transaction was amenable to taxation in India.

A. Form of Transaction over Substance of Transaction: Section 9 is a 'Look At' and not a 'Look Through' Provision

The Supreme Court stated that a document or a transaction ought to be looked at in order to construe the facts of the case. Further, one must look at a corporate holding structure with a view to uphold the basis of corporate law, which provides for the separate legal entity doctrine.

It also opined that, Section 9 of the Income Tax Act, 1961 is not a look through provision through which one can look at the substance of the transaction even if the subject matter is outside of one's jurisdiction. It is instead a legal fiction with a limited scope which ought not to be further extrapolated. The incomes that are deemed to accrue or arise in India include:

> *all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, [****] or through the transfer of a capital asset situated in India.*

Thus, clearly, the capital asset needs to be situated in India and if the *situs* of the capital asset was ignored, then the letter and the spirit of the provision would be rendered ineffective. The Court cannot blatantly ignore the words of a provision and hold them

51 Carew & Co. Ltd. v. Union of India AIR 1975 SC 2260.

52 Chaitanya K.K., *Vodafone Decision – Why it requires a review?,* International Taxation [2011] 200 TAXMAN 51 (MAG).

for no real value. Without going into the substance of the transaction, the Court stated that the *situs* of the shares of CGP was the Cayman Islands and not India and hence there was nothing connecting the transaction with the latter. Further, the Court stated that the controlling interest and other shareholders rights cannot be seen as distinct assets from the shares themselves and thus cannot be called as "assets" under Section 9 of the Act for the purpose of application of the said provision. Thus, a "share sale" is not an asset sale. Both differ in their genesis and implications.

Therefore, one could not adopt a dissecting approach to treat the "property rights" emanating from the shareholding pattern in CGP as a distinct capital assets situated in India. Therefore, on this aspect, the view of the Bombay High Court was set aside. The Court held that the substance of the transaction should take a backseat when the form of the transaction is clear enough. Thus, Section 9(1) (i) cannot be rewritten to include an indirect transfer of capital assets/property situated in India. The legislature has not used the words "indirect transfer" in Section 9(1) (i) and therefore there is nothing to presume that the section covers direct as well as indirect transfers of capital assets. A view to the contrary would be absurd as neither literal, nor purposive interpretation leads to a contrary result.

The Court also stated that the DTC Bill, 2010 proposes taxation of offshore share transactions and thus this proposal indicates in a way that indirect transfers are not covered by the existing Section 9(1)(ii) of the Act. In fact the DTC Bill, 2009 expressly stated that income accruing even from the indirect transfer of a capital asset situated in India would be covered under a deemed sale accruing in India. Absence of such a provision in the present Act would mean that Section 9 is not a look through provision.

B. Amendments Under the Finance Act, 2012

Vide the Finance Act**,** 2012, Section 9(1)(i) of the Income Tax Act was amended to *inter alia* levy tax on a "transfer of a capital asset situated in India". Explanations were inserted, with retrospective effect from April 1 1962, to clarify the meaning of the terms "transfer", "capital asset", and further expand the scope of Section 9 (1) (i) of the Income Tax Act, thereby bringing within the ambit of the Act, capital gains arising from the off-shore transfer of assets/shares, outside India. Hence, according to the Finance Act, 2012:

(i) Section 9(1)(i) was amended to clarify that the expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of".

This would greatly widen the scope of the provision as compared to what it stands at present. Amending the same retrospectively could cause a lot more companies to fall in the tax net.

(ii) Section 9 (1) (i) was amended to clarify that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.

This is clearly an effort to nullify what had been stated in Vodafone. The basis of the Supreme Court reasoning in relation to Section 9 had been that the provision does not provide to look through the transaction and does not allow indirect transfer of capital assets to be taxed. For all transactions that have not culminated as of now, it could spell doom as they could very well be brought under the ambit of this provision for any such transaction they may have entered into. The word "substantial value" remains to be defined in order to determine the tax implication arising out of transfer of a capital asset situated in India. This leaves open a window for litigation on the exact meaning of the words "substantial value". Since the same is open for interpretation, there could be substantial litigation leading to conflicting decisions among the lower authorities and the Supreme Court might need to be called in again to ascertain the correct position. The liability to tax the indirect transfer also brings with it a corresponding tax-withholding obligation on the purchaser of shares.

Further, the retrospective amendment means that every transaction, which had been undertaken in the past, but for which assessment is not yet complete, could be brought under the tax net. According to the former Finance Minister, the retrospective clarificatory amendments will not be used to reopen any cases wherein the assessment order has already been finalized. It is clear that the orders u/s 201 are considered to be assessment orders or akin to assessment orders and appealable orders under Section 246A of the Act.[53] Thus, one would need to determine, when an order could be said to have achieved finality to decide where the Vodafone issue is finally going to go to.

(iii) Section 2(14) was amended to clarify that 'property' includes and shall be deemed to have always included any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever.

This is another change that seems specific to the Vodafone decision to solidify the argument that property rights were being transferred, which had been used by the revenue department before the High Court.

(iv) Another major amendment is in relation to section 2(47) of the Act to clarify that "transfer" includes and shall be deemed to have always included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in

53 Mahindra & Mahindra Ltd. v. Dy. CIT [2009] 313 ITR 263 (Mum) (SB), Delhi Development Authority v. ITO (1998) 230 ITR 9 (Del) ,District Excise Officer, Muzaffarnagar v. ITO (2000) 68 TTJ (Del)(TM) 436, ITO v. Delhi Development Authority (2001) 252 ITR 772 (SC).

any manner (directly or indirectly, absolutely or conditionally, voluntarily or involuntarily by way of an agreement whether entered into in India or outside India) or otherwise. This is notwithstanding that such transfer of rights has been characterized as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India.

(v) Section 195(1) was amended to clarify that the obligation to comply with sub-section (1) and to make deduction there under applies extends and shall be deemed to have always applied or extended to all persons, resident or non-resident, whether or not the non-resident has:-

(a) a residence or place of business or business connection in India; or

(b) any other presence in any manner whatsoever in India.

All the above amendments have been made retrospectively and therefore it remains to be seen whether they can bring some finality to the Vodafone issue.

C. Issue relating to Corporate Veil

With respect to the piercing of the corporate veil, the judgment of the Supreme Court did not imply that the principles as laid down in *Solomon case* were sacrosanct and could never be disregarded. It also observed that the General Anti Avoidance Rules have been judicially recognized and was not new to India. However, this would not mean that the separate legal identity of corporations could be disregarded. Thus, the corporate veil, as stated before can only be lifted if the transaction is a sham or a colorable device. Further, the Supreme Court stated that the burden of proof for whether a transaction was sham lay with the Revenue Department. Therefore, the Revenue Department has to prove the same, and only if it establishes a *prima facie* case in its favor would the other party need to rebut the same. Thus, if genuine business is the purpose of a transaction, that in itself would be evidence that it was not undertaken as a colorable and artificial device. Therefore, if the "corporate business" purpose exceeds the evidence of it being a colorable device, then the transaction is not a sham.

The Court also drew a distinction between a *mala fide* transaction to avoid tax, and a *bona fide* transaction, by way of tax planning required in order to participate more effectively in the Indian Economy. The structure in the present matter had remained the same for the better part of the decade i.e. from 1998 and thus no presumption could be drawn that the transaction was a sham.

Had the structure been set up immediately prior to the transaction happening, a perverse presumption could have been drawn against it. Thus, because the twin tests of business purpose and continuity were being satisfied, no illegality could be imputed to the same.

D. Corporate Holding Structures backed by Important Business Considerations

The Court also upheld the validity of the Mauritian route for investing in India. Under Article 13 of the India-Mauritius Double Tax Avoidance Treaty, the capital gains arising out of a transaction would only be taxed in the country of the alienator. Applying the facts of the present case, to the requirements of the above provision, one realizes that the jurisdiction where the capital gains should ideally be taxed is Mauritius. But, in Mauritius, taxes on capital gains are exempt. Thus, the capital gains arising out of the subject matter of the transaction do not get taxed at all.

There being no "Limitation of Benefits" provision, the benefits under the India-Mauritius route could not be denied to any corporation. However, this does not mean that the party would be given a clean chit with respect to other aspects of tax evasion such as round tripping, fraud etc. Nevertheless, in the present case, the Supreme Court laid down that CGP cannot be said to have been evading tax as there was a valid business purpose evident in the transaction. In the absence of a business purpose, tax evasion could have been a valid ground.

E. *Azadi* and *McDowell*-Not Conflicting

The expressions tax avoidance and tax evasion, while significantly pertinent to the debate at hand, find no definition in either the Companies Act, 1956 or the Income Tax Act, 1961. The cardinal principle of "every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be" still finds favor with the Courts in many jurisdictions. Hence, tax planning *per se* can never be said to be illegitimate or illegal.

Another controversy that had plagued the Indian taxing authorities for the better part of the last decade was reconciling the apparent differences between the *Azadi* and *McDowell* cases. In *McDowell*, the Supreme Court had upheld that tax planning was legitimate as long as it was within the framework of the law; though colorable devices employed to evade tax could not be said to be legitimate. The Court also stated that it was wrong to encourage the belief that it is honorable to avoid payment of tax by resorting to dubious methods. On the other hand, in the matter of *Azadi Bachao Andolan*, it specifically addressed the question of whether using the Mauritian route was tantamount to a colorable device. Seeing no apparent disagreement between the two judgments, the Court did not agree with the Revenue department's argument that *Azadi* ought to be overruled.

The Court, agreeing with Justice Chinnappa's separate opinion on the matter stated that the need to depart from the *Wesminster Principle* was only in the context of artificial and colorable devices and thus found no conflict between *McDowell* and *Azadi*..

The Court, in order to arrive at this conclusion, looked deeply at the development of the law in United Kingdom. By looking at the *Ramsay* and *Westminster* cases, the Court

came to the conclusion that Ramsay did not discard Westminster but read it in the proper context by which a "device" which was colourable in nature had to be ignored as a fiscal nullity. Thus, Ramsay lays down a principle of statutory interpretation rather than an over-arching anti-avoidance doctrine imposed upon tax laws. Further, the Court also looked at the decision in *Craven (Inspector of Taxes) v. White (Stephen)*[54], wherein the 'look at test' was followed to determine whether there had been genuine strategic planning for tax avoidance.

If one looks at the Westminster principle, one notices that it never did give sanction to a person to order his affairs by any means, whether legitimate or illegitimate to reduce his tax burden. *Azadi,* by restoring the Westminster principle, is only affirming the sanctity of tax planning, as we know it. What *McDowell* goes on to state is also correct as it simply lays down that while tax planning is legitimate, the same must not be done *via* colorable devices. Mauritius, along with the Cayman Islands etc are known tax havens, and there are obviously certain benefits in relation to the capital gains taxes that are incident to a party if it does transacts through these routes. Thus, it is only logical that every party would want to set up their businesses in Mauritius to take advantage of the benefits that arise. Merely because there has been a transaction through a Mauritian entity, would not cast a shadow of doubt over the same, fuelling a contention that it is a sham transaction.

One can only look at the form of the transaction to see if there are discrepancies, and if there is none, the substance cannot be gone into. The motive of the transaction being to avoid taxes would not *per se* invalidate it in the absence of a particular enactment that prohibits transactions of that type. The Court can only decide based on the law of the land as it exists at the time of the decision, and if there is nothing to prohibit a transaction of such nature, then irrespective of the economic hardship that is being caused, there could be no liability accruing on the persons involved. It is the task of the Court to ascertain the true legal nature of the transaction and while doing so it has to not adopt a dissecting approach but look at the transaction in question as a whole.

It is true that the same might result in a loss to the exchequer. However, the judiciary is not run by economic considerations and needs to look at the legal scenario before arriving at a conclusion. It could be true that the same is an archaic colonial model that results in a colossal loss of revenue; however, if on the other hand the substance of the transaction were looked at in every transaction that takes place, the same would only result in endless litigation and chaos.

Benefits that are allowed under a particular treaty or a law in force cannot be denied on the ground of economic loss, which can never be the sole consideration to determine the legality of a transaction.

54 (1988) 3 All. E.R. 495

The Court stated that the authorities might invoke the "substance over form" principle or "pierce the corporate veil" only after it is able to establish based on the facts and circumstances surrounding the transaction that the impugned transaction is a sham or specifically structured to be tax avoidant. Every strategic foreign investment flowing into India should be looked at in a holistic manner, bearing in mind factors such as: the concept of participation in investment; the duration of time during which the holding structure exists; the period of business operations in India; the generation of taxable revenues in India; the timing of the exit; and the continuity of business on such exit. As for now, only time will tell where the tussle between the investment favoring and tax favoring approach will reach.

The *McDowell* decision cannot be read as leading to a conclusion that all tax planning is illegal, illegitimate or impermissible. It only related to a specific case situation wherein there were colorable devices present. Furthermore, it is for the judiciary to understand that clauses such as "Limitation of Benefits" have to be incorporated into a treaty and cannot be read into by interpretation. Furthermore, all the references in *McDowell* as regards to departing from the Westminster principle were in the context of artificial and colorable devices.

Thus, there can be no discernible difference of opinion in what was expressed in *Azadi* and *McDowell*. While the latter expressed an opinion in specific circumstances, the former reiterated the general rule to be followed except in the case situation mentioned in the latter.

F. Applicability of S. 195 of the Income Tax Act, 1961 on Non-residents

The Court categorically stated that the transaction in the present matter was the outright sale of an asset situated outside Indian by a non-resident to another non-resident. Thus, with no taxable presence in India, it would be naive to suggest that Section 195 of the Act should apply.

After reviewing cases such as *Clark v. Oceanic Contractors*, and *Eli Lilly*, Justice Radhakrishnan further remarked that withholding tax provisions under Section 195 of the Income Tax Act would apply only in cases where payments are made by a resident to a non-resident. In other words, it has been held that payments between non-residents are not subject to withholding taxes under the Income Tax Act.

Further, the Court also stated that Vodafone couldn't be held as a representative assessee for Hutchinson's tax liability as:

1. Under Section 163 which provides for who may be regarded as a representative assessee, withholding tax is not mentioned.

2. A person ought to be an agent of the recipient of income in order to qualify as a representative assessee. Further, such agency ought to be for the purposes of that income which can be deemed to accrue or arise in India, and not all agents could qualify as representative assessee.

The court observed that neither of the above-mentioned conditions applied in this case and thus Vodafone cannot be called as a representative assessee of Hutch. Thus, in conclusion, for the purposes of determining whether a transaction is sham or bogus, the following considerations need to be kept in mind:

- the concept of participation in investment
- the duration of time during which the Holding Structure exists
- the period of business operations in India
- the generation of taxable revenues in India
- the timing of the exit
- the continuity of business on such exit.

VI. Conclusion

> *Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.*
>
> -Judge Learned Hand, U. S. Court of Appeals, *Gregory v. Helvering*[55]

The High Court decision tried fervently to mould theory with practise while trying to assert that assets were transferred in the form of rights. However, the decision failed on many counts and according to many, common sense has prevailed. The Supreme Court, on the other hand, has very clearly laid down the law on many aspects. The Vodafone decision [SC], while being very simple in its terminology has more far reaching consequences than any other judgment in the recent past. Some of the major transactions in recent history in which the government has seen a potential to raise significant tax revenue include Kraft Food's $19 billion purchase of Cadbury's, Vedanta's $8.6 billion acquisition of Cairn India, global beer giant Sab Miller's buyout of Foster and Sanofi Aventis' acquisition of Shanta Biotech. Now, as a consequence of this judgment, the

55 69 F.2.d 809.

Revenue is bound to lose out on billions in tax. Thus corporate entities must keep the above decision in mind while going for tax planning and if possible, obtain a nil withholding tax order from the tax authority before going forward with the same.

According to the United Nations Conference on Trade and Development (UNCTAD), India is set to become the second best destination for FDI by Dec. 2012, pushing the U.S. down to fourth best. However, considering the perennial uncertainty surrounding India's tax and regulatory regime, the same seems to be at risk momentarily.[56] However, as we have seen the tussle between Vodafone and the Indian Government seems set to cross into lands unknown and beyond the power of the Supreme Court itself. If the revenue wants to stem the "loss of revenue", then instead of trying to retrospectively amend the laws to include 'those' that got away, it should instead amend the relevant provision in the Income Tax Act, 1961 and the relevant Double Tax Avoidance Agreements, prospectively.

What is viewed as legitimate tax planning and what is intolerable tax evasion cannot be left to conjecture and surmise. The Supreme Court has thus upheld the rule of law by reading the latter and the spirit of the law instead of the relying on the economic motivations of the Government of India. It needs to be seen whether this retrospective amendment would be challenged or not.

Recent trends show that with the passing of the Budget and Finance Act, 2012 and the additional complications that it has brought to the Indian tax-regulatory environment, British telecom giant- Vodafone will not look to the Indian courts to come to its rescue anymore. It is set to rely on International Arbitration under the India-Netherlands Investment Protection Agreement to state that it has not been afforded 'fair and equitable treatment of investments', thereby violating legal protections granted to the company.[57] The Indian Government feels that the notice is premature and that tax issues are not covered under India-Netherlands Bilateral Investment Protection Agreement.[58] Vodafone on the other hand feels that it is being specifically targeted by the retrospective amendments, as there has not been any inkling to tax any other transaction that had happened prior or subsequent to 2007.[59] Further, while retrospective amendments in tax laws is not unheard of, this is the first time wherein a company despite having emerged victorious as a result of a judgment based on merit from the highest court in

56 *Taxing Times, What Will the Vodafone Case mean for Cross Border M & A* (Dec 21, 2011), *available at* http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4529.

57 Joji Thomas Philip & Vinay Pandey, *Vodafone To Opt For International Arbitration Against Indian Tax Authorities* (May 29, 2012), *available at* http://articles.economictimes.indiatimes.com/2012-05-29/news/31888046_1_vodafone-notice-vodafone-plans-indian-tax-authorities.

58 *No Cause of action': Govt tells Vodafone*, Indian Express (May 30, 2012), *available at* http:/www.indianexpress.com/news/no-cause-of-action-govt-tells-vodafone/955729/0.

59 *Supra* note 55.

the land is required to cough up tax for the same transaction in question. Thus, the Vodafone case has taken a new turn, wherein the parties now seem bored of conventional litigation and seem ready to try out other means of dispute resolution. Whether arbitration can do what the litigation could not, remains to be seen.

It can only be hoped that after the incessant litigation, and most probably arbitration or settlement as the case may be, the matter and those concerned with it will get the respite that they deserve.