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# NMIMS STUDENT LAW REVIEW

Volume III  
March 2021

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NMIMS  
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LAW REVIEW

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## FROM THE DEAN'S DESK

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Our journey to institutionalise research by students begins with this publication. Though students publish quality research in highly acclaimed journals, it was felt that the culmination of ideation can only begin when nurtured from our level. Our attempt is to openly welcome good quality research articles from research scholars objectively. I say with pleasure that when review articles were solicited, we were surprised with the huge response from across the country. After due peer-review process, we selected some original research articles and comments. I am sure this will generate appreciation and constructive dialogue from the readers.

Kirit P. Mehta School of Law has received worthy endorsements from the industry, academia, judiciary, bar, law firms, MNC's and regulatory bodies like SEBI. We welcome and thank our esteemed Board of Advisors and Peers who have timely guided this edition to become part of a discourse that generates and challenges existing paradigms of legal jurisprudence. I congratulate the Editor-in-Chief and each member of the Editorial Board for their time and contribution to the growth of NMIMS Student Law Review. I urge the readers to give wings to the thoughts presented by our contributors.

- **Dr. Alok Misra**



## MENTOR'S MESSAGE

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It was a moment of pride for us when the Law Review was launched, in 2018, under the guidance of our Dean and Faculty In-Charge. That the Journal has received such an overwhelming response from authors, all budding young professionals, is a sign that we are going in the right direction. I congratulate all the authors whose works have made it here, after a thorough and lengthy process of review. The experience of researching, writing, formatting, and eagerly waiting for a response from the Editorial Team must be worth the wait. The sense elation is incomparable.

To those who missed out, I hope that you keep going with your writing endeavours. The experience of researching and writing on the numerous questions of law is in itself a rewarding and enriching experience, and a skillset of immense value in our industry. Unfortunately, the Editorial Team can choose only a handful of articles from the entries received. I am sure they had a hard time choosing which papers edged out the others by the slightest of margins.

To the Editorial Team, I congratulate you on successfully publishing the Third Volume, the culmination of a year of planning, waiting, reviewing, editing, proofreading, and piecing together a manuscript that will contribute significantly to the literature of our noble industry. I hope each and every one of you found the experience enlightening, and will go on to play a role in developing the research culture in the field of law.

- **Mr. Harshal Shah**

## ACKNOWLEDGMENT

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This third issue of NMIMS Student Law Review has been a collective effort right from the moment we conceptualised its theme. We extend our gratitude to our Hon'ble Vice Chancellor, NMIMS University for his constant support and encouragement. The Dean of the NMIMS Kirit P. Mehta School of Law Dr. Alok Misra for entrusting us with this responsibility of editing the third issue of NMIMS Law Review on Contemporary issues. We hope that this issue will be unprecedented in terms of the breadth and depth of the theme being covered. We could not have carried through this project successfully without his encouragement.

We thank the Registrar of NMIMS University for her continued support. We would also thank the administrative department; our Board of peer reviewers for their time and close reading of the articles; our faculty colleagues who have always provided the intellectual space and friendship that help sustain projects like these and make them a happy affair. We must also thank our contributors who so encouragingly responded to our call for papers, were very cooperative with keeping deadlines, and thought of us as a worthy venue for publishing their scholarship. It is your work that makes this special issue special.

Our team also deserves a very special mention: Our Student head Ms. Sampurna Kanungo, Student Co-head Sara D'Sousa, Co-Editor

in-Chief Astha Nahar, Student Co-ordinator Mr. Apurva Doshi along with the whole team of Associate Editors have been absolutely fantastic to work with. Their dedication and professionalism are reasons why we have been able to pull this issue through to fruition. Last but not the least, thank you to our Mentor Mr. Harshal Shah for his inspiration and provocations that always ensured that we do not compromise on theory, and never suspend criticality. Your intellectual engagement and scholarship forms an essential foundation of this special issue.

- **Prof. Richa Kashyap**

**Faculty-In charge and Editor-in-Chief**

## STUDENT'S MESSAGE

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My heartiest congratulations to the team of NMIMS Student Law Review. The publication of Volume III brings me immense joy and satisfaction. Successfully completing the editorial process during this uncertain period attests to the Editorial Board's dedication towards the development of legal research and literature in our institute, our country, and the legal world at large.

The high quality of literature the journal receives demands an elaborate series of editorial processes. It has been the commitment of the journal to curate the most well-researched and well-expressed analyses of legal advances in our times. Student Editors are the heart of this process, and it is exciting to see the enthusiasm and passion of the present team. I hope that your association with, and efforts towards the journal brings you immense success and recognition in your careers.

My tenure with the Law Review – first as an Associate Editor and later as Student Head – were undoubtedly the most enriching and rewarding years of my student life. I feel privileged to call the best minds of our institute, across batches, as my colleagues, mentors, and friends through our association with the journal. From all of them, I have learnt not only to hone my research, writing, and editorial skills, but the importance of qualities like patience, determination, initiative, and varying styles of leadership to suit the hour.

My special gratitude to Ms. Richa Kashyap, Faculty Head and Editor-in-Chief, for mentoring three boards of student editors. The opportunity to be part of the Law Review team has been an invaluable one. I believe that everyone associated with the Journal has contributed to the evolution of law and development of constructive, intellectual thinking, and look forward to each future volume with unbridled excitement.

- **Shaarang Anirudh**

**Head, NMIMS Law Review 2019-2020 (Volume II)**

## FOREWORD

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It gives us immense pleasure in publishing this third volume of the NMIMS Student Law Review. We hope our sincere endeavour advances legal scholarship and furthers contemporary academic discourse, for many years to come. We continue on a strong note as in this edition, the authors have addressed wide-ranging legal questions with great profundity and critique.

Adithya Anil Variath, in the paper titled *“Legalized Politics Of Recognition Of States In International Law: A Case Of ‘Realpolitik’, Not Law”* embarks on an insightful analysis of past occasions of state recognition in international law, to draw out a pattern of political influence prevailing over the fulfilment of objective legal criteria. The author argues that this practice has largely lead to a sense of arbitrariness and instability in international law - preferring states that cull favour with more powerful nations, and leading to large-scale inequity between developing and underdeveloped nations. Concluding with the suggestion that ancient Indian patterns of recognition may be more helpful to adopt in an evolving world, this paper certainly makes for interesting reading.

In their paper titled *“The Indian Mutual Fund Industry: Regulatory Evolution and the Contemporary Chinks in the Armour vis-à-vis Crises like Franklin Templeton 2020”*, Jessica Kaur and Srishti Kaushal delve into the history of Mutual Funds in India, drawing out the key factors which helped it evolve into the towering - albeit somewhat shaky - industry it is today. With a critical lens, the authors then analyse the reasons for the Franklin Templeton crisis of 2020, and ascertain the loopholes in the regulatory regime to posit constructive solutions.

In *“A Holistic Study of the Legality of Pay for Delay Agreements- An Indian Perspective”*, Nishant Pande & Urja Dhapre discuss the convoluted position of pay-for-delay agreements in the Indian legal

framework, particularly from the perspective of intellectual property law, contract law and competition law. This article assumes significance in light of the tussle between intellectual property rights of the manufacturers of novel vaccines developed to battle the ongoing pandemic, and public health considerations.

In her article titled *“Evolution Of Prima Facie Special Equities In Light Of Interim Injunctions Under Section 9 Of The Arbitration And Conciliation Act 1996”*, Priyanshi Sarin has explained the Evolution of prima facie special equities in light of Interim Injunctions by drawing out the history of special equities by different courts along with the tests followed by them to reach a conclusion. She has further analysed the term “Special equities” in relation to the Arbitration and Conciliation Act along with the grey areas with regards to “enforcement of interim orders”. The author has added a contemporary aspect to the paper by analysing the use of defence of COVID-19 as a ground for injunction. Lastly, the author has critically examined the importance of having uniform guidelines in the present injunction regime.

Karan Ahluwalia in his article titled *“The Panopticon: From Bentham, Through Foucault To The Surveillance State”* has critically analysed and compared the existence of surveillance state in the 21st century with the essence of the Panopticon as envisioned by Bentham. In addition to a contemporary aspect in the paper, the author has further argued the ideology from both the sides by using contemporary judgements and incidents. Lastly the author has expressed his ideas on how the two concepts and ideologies can be collated and resolved.

In their article titled *“Migrant Crisis in India - A Pandemonium Over a Pandemic”* Aishwarya Vardhan and Sanjana Sharma study the plight of migrant workers in the context of COVID-19 and provide a constructive critique of the policies that are being brought recently.

Divij Jain in his article titled *“Credit Default Swaps and Insurance: The Perpetual Characterization Conundrum”* elucidates the common law principles of insurance like good faith, indemnity etc. and corresponds them with the framework of a typical Credit Default Swap. The author explores the confusion regarding the treatment of CDS as a contract for insurance purposes and establishes a further need to examine the scope and extent of insurable interest with reference to a CDS contract.

In *“Protecting the Rights of Children under the Draft Data Protection Bill”*, Divya Pinheiro analyses the rights of an especially vulnerable and overlooked category of individuals i.e. children within the personal data protection regime of India. The author examines the adequacy of the provisions of the draft Personal Data Protection Bill in safeguarding privacy interests of children, and draws a parallel with the extent of protection granted under mature jurisdictions such as the EU and the USA.

Having been reviewed by a panel of established professionals and academicians from the legal fraternity, these articles were subject to informed scrutiny. The entire team behind this edition deserves applause for their tireless efforts and dedication to facilitate the publication of quality legal literature.

**Board of Editors**

At Mumbai, MH

March 2021



LONG

ARTICLES

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**LEGALIZED POLITICS OF RECOGNITION OF STATES IN  
INTERNATIONAL LAW: A CASE OF 'REALPOLITIK',  
NOT LAW**

- **Adithya Anil Variath\***

**ABSTRACT**

*No other subject of international legal theory and jurisprudence appears to interweave politics and law like the politico-legal decisions of recognition of States. It is the element of "recognition" that enables a States to engage as a 'recognized entity' in legal relations with other States in the conduct of its foreign relations. This recognition of sovereignty grants legal sanctity to actions like the request for military support from other States, refusal of entry to foreign military forces in home State and rights like negotiation and conclusion of international agreements. Recognition is a denouement of the discretionary power of States. And what crystallizes into this discretion is the diplomatic prejudice and interests of States, including the changes in the domestic political system, the personal preferences of leaders or favouritism of political parties in the deciding state, the relations between the deciding state and the state in which the government has changed, the nature of the provincial subsystem, and the nature of global order. History of international law has also witnessed decisions being concocted on the distribution of power and the level of ideological consensus between states. Purely political grounds for both recognition and non-recognition are criticized for being arbitrary and self-serving. Recognition as a long-standing legal institution has an important function of identifying major actors in the international system.*

*This article focuses on how the legalized politics of the politicized decision of recognition of States has been maligned by the international community to infuse arbitrariness, uncertainty and instability into the*

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\* Adithya Anil Variath, LL.M. (International Law), Dharmashastra National Law University, Jabalpur, Available at: [variath.adithya@gmail.com](mailto:variath.adithya@gmail.com)

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*international law regime. The author also attempts to structuralize legal concepts and declassify the power-oriented politics of “recognition” keeping the ne plus ultra of the procedural equity, rule of law and justice as its touchstone.*

**Keywords:** International Law, Statehood, State Recognition, International Politics, TWAIL

## I. INTRODUCTION

It is an undeniable sociological fact – as also propounded by the historical jurisprudence thinker Savigny – that whenever there is a society, whether national or international, there is a law to satisfy the society's sociological needs and historical interests. The necessity of a 'Law of Nations' did not arise until a multitude of states, independent of one another, had successfully established themselves.<sup>1</sup> The present system of international law is, therefore, of recent origin. According to Starke:

*"[M]odern international law is that body of law which is composed for its greater part of the principles and rules of conduct which states feel bound to observe, and therefore, do observe in their relations with each other."*<sup>2</sup>

But despite a certain degree of parallelism, if not similarity between the contours of the concept of 'law' in the national order and 'law' in the international order, a substantial distinction exists in the inclusiveness of political actions facilitating legal decisions.

The present-day liberal international order has seen a power-oriented integration of law and politics. In a democratic domestic system where the law is a relationship between an individual and the state, law-making is an exclusive prerogative of the legislature. Laws are drafted and enacted regularly as a result of a non-legal process of political bargaining, based on the preferences of those who represent the population in the parliament. Even majoritarian politics and authoritarianism has seen strict integration of populism masquerading as politicized legal developments.<sup>3</sup> But constitutional

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<sup>1</sup> LASSA OPPENHEIM, *INTERNATIONAL LAW: A TREATISE*, VOLUME 1 PEACE 58 (1905).

<sup>2</sup> I A SHEARER, *STARKE'S INTERNATIONAL LAW* 3 (11th Ed., 1994).

<sup>3</sup> Democracies tend to justify that a rule of international law does not pre-empt the application of a conflicting norm of domestic law in specific contexts. See J. RAZ, *THE AUTHORITY OF LAW* (1979); Joseph Landau, *New Majoritarian Constitutionalism*,

democracies around the world are witnessing transformations due to principles like transformative constitutionalism,<sup>4</sup> subaltern constitutionalism<sup>5</sup> and progressive realisation<sup>6</sup>, which are disintegrating populism and legislative reverence.<sup>7</sup> Although a clear differentiation between law and politics can never be achieved, a thin line between individual political calculations and actions of the state is necessary to ensure legal certainty and lack of arbitrariness. The international law regime, being fundamentally based on the common consensus of equal and sovereign states, is yet to behold such a transformation from power to justice. No other practice of international law has interlinked politics and law like the evolutionary pattern of “state recognition”. Recognition in modern times is a method to facilitate crystallising of sovereignty and strengthening authoritative power *i.e.*, it is the acknowledgement of the status of a State as a legal entity. Asian and African countries have suffered during the nineteenth and early twentieth century because of the non-recognition of these states as members of the international communities. Non-recognition of the region led to

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103 IOWA L. REV. 1033 (2018); Mattias Kumm, *The Legitimacy of International Law: A Constitutionalist Framework of Analysis*, 15 THE EUROPEAN JOURNAL OF INTERNATIONAL LAW 5, 908 (2004).

<sup>4</sup> Transformative constitutionalism in this context is the structured method of progressive changes in the basic values of Constitutionalism. See Carys Hughes, *The Transformative Potential of Constituent Power: A Revised Approach to the New Latin American Constitutionalism*, 46 LATIN AMERICAN PERSPECTIVES 6 (2019); Julian Arato, *Treaty Interpretation and Constitutional Transformation: Informal Change in International Organizations*, 38 YALE J. INT’L L. (2013).

<sup>5</sup> See Upendra Baxi, *Postcolonial Legality: A Postscript from India*, 45 VERFASSUNG UND RECHT IN ÜBERSEE / LAW AND POLITICS IN AFRICA, ASIA AND LATIN AMERICA 2, 178-194 (2012).

<sup>6</sup> Robert Jervis, *Realism in the Study of World Politics*, 52 INTERNATIONAL ORGANIZATION AT FIFTY: EXPLORATION AND CONTESTATION IN THE STUDY OF WORLD POLITICS 4, 971-991 (1998); Stephen M. Walt, *The Progressive Power of Realism*, 91 THE AMERICAN POLITICAL SCIENCE REVIEW 4, 931-35 (1997)

<sup>7</sup> Cf. Upendra Baxi, *Demosprudence versus Jurisprudence: The Indian Judicial Experience in the Context of Comparative Constitutional Studies*, 14 MACQUARIE LAW JOURNAL 3, 6-21 (2014).

instability and subjugation of democratic values in the Asian and African region.<sup>8</sup> The recognition of many new countries in these third world region was due to protracted revolution leading to decolonization.

Patterns of the decisions taken by nation-states to recognise or not recognise states are largely based on considerations of diplomatic relations and geopolitical advantages that may accrue by granting them recognition. This leads to both: the strategic non-recognition of states despite their fulfilment of objective parameters; and also the recognition of states despite their inability to fulfil the objective parameters of attaining statehood. The United States of America's ally Israel was recognized by the US immediately following its declaration of independence, but the US has granted Palestine a 'special status'.<sup>9</sup> On the other hand, nine members of the Organisation of Islamic Cooperation and nineteen of the twenty-one members in the Arab League do not recognize or do not maintain diplomatic relations with Israel, however, these states recognize Palestine.<sup>10</sup> However, with Israel becoming a geopolitical power having a constructional potential to change the discourse of global

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<sup>8</sup> Cheikh Anta Babou, *Decolonization or National Liberation: Debating the End of British Colonial Rule in Africa*, 632 *THE ANNALS OF THE AMERICAN ACADEMY OF POLITICAL AND SOCIAL SCIENCE* 41-54 (2010). Konrad Ginther, *Re-Defining International Law from the Point of View of Decolonisation and Development and African Regionalism*, 26 *JOURNAL OF AFRICAN LAW* 1, 49 (1982).

<sup>9</sup> The Arab-Israeli War of 1948, Office of the Historian, DEPARTMENT OF STATE - UNITED STATES OF AMERICA (Apr. 9, 2020, 7.30 PM), <https://history.state.gov/milestones/1945-1952/arab-israeli-war>.

<sup>10</sup> History of the Question of Palestine, UNITED NATIONS, <https://www.un.org/unispal/history/>. See Diplomatic Relations, Permanent Observer Mission of the State of Palestine to the United Nations, New York (Apr. 9, 2020, 7.30 PM), <https://palestineun.org/about-palestine/diplomatic-relations/>.

policy making, Arab nations have begun normalising diplomatic ties with Israel through open diplomatic and commercial means.<sup>11</sup>

Similarly, modern international relations theory is also witnessing the development of “not recognise, but collaborate”. Republic of China (Taiwan) does not officially conduct relations with Israel because Israel recognizes the People’s Republic of China.<sup>12</sup> However, Republic of China (Taiwan) collaborates with Israel on matters of arms trade.<sup>13</sup> Today’s geopolitics have seen public secrets and informal diplomatic relations i.e. Israel and Taiwan,<sup>14</sup> in these cases breach of diplomatic relations can imply non-recognition only when the government in one of the states has never been recognized by the government in the other.

The United Nations recognizes the sovereignty of the Republic of Cyprus on the whole territory of Cyprus, however, the Turkish Republic of the Northern Republic of Cyprus declared in 1974 has never ceased to exist.<sup>15</sup> Somaliland has governed itself for over a decade since it successfully broke from Somalia, but has yet not received any formal recognition from the international community.<sup>16</sup>

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<sup>11</sup> Peter Baker, *Israel and United Arab Emirates Strike Major Diplomatic Agreement*, N.Y. TIMES, Aug. 13, 2020.

<https://www.nytimes.com/2020/08/13/us/politics/trump-israel-united-arab-emirates-uae.html>

<sup>12</sup> Roie Yellinek, *Taiwan and Israel: Don’t Recognize, but Collaborate*, BESA CENTER PERSPECTIVES PAPER NO. 1,480, Mar. 12, 2020, <https://besacenter.org/perspectives-papers/taiwan-israel-collaboration/>

<sup>13</sup> Jonathan Goldstein, *A Quadrilateral Relationship: Israel, China, Taiwan, and the United States Since 1992*, 12 AMERICAN JOURNAL OF CHINESE STUDIES, 177-202 (2005).

<sup>14</sup> Mor Sobol, *Revisiting Israel-Taiwan relations*, 25 ISRAEL AFFAIRS 1026-40 (2019).

<sup>15</sup> See Lawrence Hargrove et al., *Cyprus: International Law and the Prospects for Settlement*, 78 PROCEEDINGS OF THE ANNUAL MEETING (AMERICAN SOCIETY OF INTERNATIONAL LAW) 107-32 (1984).

<sup>16</sup> (Anonymous), *Government Recognition in Somalia and Regional Political Stability in the Horn of Africa*, 40 THE JOURNAL OF MODERN AFRICAN STUDIES 247-72 (2002).

For an entity to be called a State and to enjoy the consequent rights and privileges under international law, it is a prerequisite that the purported State's existence of the state is accepted and acknowledged by the members of the international community. India prematurely recognized Bangladesh before it had a stable government. When the newly formed Bangladesh (then East Pakistan) sought admission into the United Nations club, their request was vetoed by Pakistan's premier ally China. The United States, which at the time was another key ally of Pakistan, was one of the last member states to recognize Bangladesh as an independent state. Recognition of Bangladesh by Pakistan was also a political move under the 1972 Shimla Agreement: Pakistan recognized the independence of Bangladesh in exchange for Pakistani prisoners-of-war.<sup>17</sup>

The problem of recognition of a government arises even in the case of existing States as revolutions occur or military conquests are antagonized, and the status of the new government or authority administering the territory becomes a matter of concern to other States. Other states often have trade and diplomatic relations with the displaced governments. In 1991, the Haitian military with the support of police authorities overthrew the elected Government in power headed by Jean-Bertrand Aristide, President of Haiti.<sup>18</sup> These authorities took complete control over Haiti. However, the coup was condemned by the international community by imposing economic and military sanctions on Haiti.<sup>19</sup> International institutions refused

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<sup>17</sup>James P. Sterba, 2 Months After Simla, N.Y. TIMES, Sept. 4, 1972, <https://www.nytimes.com/1972/09/04/archives/2-months-after-simla-china-and-bangladesh-seen-deflating-peace.html>.

<sup>18</sup>Haiti's Military Assumes Power After Troops Arrest the President, N.Y. TIMES, Oct. 1, 1991, <https://www.nytimes.com/1991/10/01/us/haiti-s-military-assumes-power-after-troops-arrest-the-president.html>

<sup>19</sup>Don Bohning, International Sanctions on Haiti, GLOBAL POLICY FORUM, Mar. 1, 1999, <https://www.globalpolicy.org/global-taxes/41742.html>. See also the



to engage in normal diplomatic relations with them or to seat their representatives at international organisations and instead continued to recognize the exiled President Aristide as a representative of the legitimate government of Haiti. Due to the pressure exerted by the international environment, it was impossible for the coup leaders to control the affairs of the State. Finally, in 1994, the coup leaders were forced to relinquish power and then-President Aristide returned to Haiti and the government under him took reins of the state administration.<sup>20</sup> A recent example of a similar incident is the 2021 Myanmar coup d'état on 1 February 2021. The coup was not well received by the international community with United States' President Joe Biden raising the threat of new sanctions, followed by the United Nations condemning the coup and not recognising the legitimacy of the Coup.<sup>21</sup>

International law is a medium to facilitate global governance, *i.e.* to ensure the rule of law in the international order. History is rich with examples where States have considered geopolitics over procedural competence when it comes to recognition of other states. When strategic factors take primacy over objective characters laid down by law, there tends to be a prevalence of uncertainty over the mandate of procedural adequacy. Arbitrariness arises when legal principles are not applied consistently or there is no legal principle. The legitimacy of transitional justice is seeking a more nuanced understanding of the nexus between politics, power, and the law of recognition of States. The legal justifications adopted by members of the international community to recognize some and not recognize

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Venezuelan Gold decision delivered by the English Court of Appeal judgment in the case of *Maduro Board v Guaidó Board* [2020] EWCA Civ 1249 (United Kingdom).

<sup>20</sup> SEAN D. MURPHY, *DEMOCRATIC GOVERNANCE AND INTERNATIONAL LAW* 123 (Gregory H. Fox, Brad R. Roth et al. Eds., 2000).

<sup>21</sup> Security Council Press Statement on Situation in Myanmar, SC/14430, Feb. 4, 2021, <https://www.un.org/press/en/2021/sc14430.doc.htm>.

some are shrouded in geopolitics. This article sketches out how the subject of recognition of States has over time transformed into a political discretion from a legal obligation, despite the development of the international law regime as a model of global governance. Part II of the article deals with the functional analysis of the terminology of “statehood”. Part III delves into reconceptualising rule of law in recognition of States. Part IV deals with the Indian approaches to recognition and Part IV details the fourth world approaches to the international law of recognition.

## **II. “STATEHOOD”: A FUNCTIONAL ANALYSIS OF THE TERMINOLOGY**

In the era of Globalisation, the global order is shifting towards a Duguitian model of social solidarity. Leon Duguit regarded social solidarity or interdependence not as a rule of conduct or imperative but a fundamental fact of human existence.<sup>22</sup> In today’s transnational world, States have become more integrated and function in an interdependent world of ‘problems without passports.’<sup>23</sup> This interdependence has made recognition of States as an essential concept for survival and a precondition to legitimize the functioning of a State in the international order. The international order is ultimately a community of states. A non-recognized State’s capability to enter into relations with another state albatrosses due to its isolation from the international community.

Communities inherently can never be constant and static. They are a constantly evolving socio-political institution. And the State is the central subject of international law. A picture of the world map for a layman may be a reflection of several states divided by

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<sup>22</sup> See, e.g., Robert Kolb, *Politis and Sociological Jurisprudence of Inter-War International Law*, 23 *EUROPEAN JOURNAL OF INTERNATIONAL LAW*, 233–241 (2012); F. W. Coker, *Reviewed Work: The Law and the State by Léon Duguit*, 12 *THE AMERICAN POLITICAL SCIENCE REVIEW*, 536–540 (1918).

<sup>23</sup> Cf. Kofi A. Anan, *Problems Without Passports*, *FOREIGN POLICY*, Nov. 9, 2009, <https://foreignpolicy.com/2009/11/09/problems-without-passports/>.

territorial boundaries. But from a legal prism, the concept of “State” is above and beyond territorial bifurcations. The concept of “State” has found extensive reliance on the international ‘constitutional’ instruments and documents such as the United Nations Charter. The state as a legal entity in international law is formalized when it is recognized as such by other States. In traditional international law, the nature of statehood is conceived when the entity possesses the following qualifications as postulated by Jellinek’s “*Drei Elementen Lehre*”, which affirms that a State consists of three essential elements: a government (*Staatsgewalt*), a territory (*Staatsgebiet*) and a population (*Staatsvolk*).<sup>24</sup> The end of the Cold War was the beginning of new ambiguities in the recognition of States, with the making of universal calls for equal status and equal rights by nation-states.

Recognition of State implies inscription of the French revolution principles of liberty, equality and fraternity in an international domain, *viz.* the independence of States, the sovereign equality of States and the obligation of States to peacefully coexist.<sup>25</sup> The Post-Westphalian model of sovereignty formalized several principles that underline today’s international relations structure; including the principle of legal equality between states and the principle of non-intervention in the internal affairs of another State.<sup>26</sup> The idea of territoriality of the state became more prominent with the Hobbesian model of governance and the emergence of war as the new normal. Two traditional theories were developed to understand the abstract character of the State. First, the “property theory or *Eigentumstheorie*”: according to this theory, the territory is an object of the State’s property and the State possesses a territory.<sup>27</sup> Second,

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<sup>24</sup> See GEORG JELLINEK, ALLGEMEINE STAATSLEHRE 3-70 (2015)

<sup>25</sup> NATHALIE HORBACH ET AL., HANDBOEK INTERNATIONAAL RECHT 160 (2007).

<sup>26</sup> See ANDREA BIRDSALL, THE INTERNATIONAL POLITICS OF JUDICIAL INTERVENTION 40-41 (2009).

<sup>27</sup> E. MILANO, UNLAWFUL TERRITORIAL SITUATIONS IN INTERNATIONAL LAW: RECONCILING EFFECTIVENESS, LEGALITY AND LEGITIMACY 67 (2006)

the attribute theory or “*Eigenschaftstheorie*”. According to this theory, the State does not possess a territory, but the State is its territory. Other attributes of statehood are people, government, and sovereignty. This development paralleled with the development of nationalism as a core political philosophy. According to nationalistic political philosophy, the territory is just an attribute of the State.

Modern international law adopts an extension of the theory developed by Hans Kelson’s Viennese School of Legal Theory, known as the “competence theory”. According to this School of thought, the State as a normative legal order is constrained by territory and a population.<sup>28</sup> These principles were crystallized into a codified law under Article 1 of the Montevideo Convention on the Rights and Duties of States of 1933, which reads:

*“[T]he State as a person of international law should possess the following qualifications: (a) a permanent population; (b) a defined territory; (c) a government; and (d) capacity to enter into relations with the other States.”*

These four fundamental elements are used as a criterion for the recognition of states. However, Article 3 of the Montevideo Convention on the Rights and Duties of States of 1933 also declares that statehood or the political existence of a State is independent of recognition by other states. Article 3 implies that a State can continue to exist without recognition from the majority of other states in the international order. Harmoniously constructing Article 1 with Article 3 makes it clear that the elements of the Montevideo Convention were primarily intended as criteria for assessing the creation of States and not as criteria for assessing the continuation of States.

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<sup>28</sup> See NATHALIE HORBACH ET AL., *HANDBOEK INTERNATIONAAL RECHT* 163-64 (2007).

### *A. Reappraisal of two paradoxical theories*

Despite having international norms entering the mainstream to streamline decisions of recognition, the act due to its politico-legal nature is seldom free from ambiguities. The foreign policy actions of a state have both domestic and foreign consequences. And if domestic consequences are detrimental for the recognising of a state's legal-economic climate, a state may within its legitimate power impose conditions on law and policy while recognising another state, for the maintenance of international order and integrity.<sup>29</sup> Two theories have been developed to provide a framework for recognition in international law. The "constitutive theory" views recognition as the voluntary act of the recognizing state and the "declaratory theory" accepts recognition as automatic.<sup>30</sup>

The constitutive theory finds support in positivism from thinkers like Kelsen, Anzilloti, Triepel and Oppenheim,<sup>31</sup> who posit that "A state is and becomes an international person through recognition only and exclusively."<sup>32</sup> A clear emphasis on the formal act of recognition shows that a new entity formed cannot claim to participate in the international order, even though it may possess all of the characteristics of statehood unless there is a formal recognition of its existence by other players in the community.

The constitutive theory is fundamentally flawed and widely criticised due to its moral implications. According to the constitutive theory, recognition of a state is not automatic but depends on the

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<sup>29</sup> Richard Caplan, *Conditional recognition as an instrument of ethnic conflict regulation: the European Community and Yugoslavia*, 8 *NATIONS AND NATIONALISM* 2, 157-177 (2002).

<sup>30</sup> Fred L. Morrison, *Recognition in International Law: A Functional Reappraisal*, 34 *THE UNIVERSITY OF CHICAGO LAW REVIEW* 857 (1967).

<sup>31</sup> See, H. Lauterpacht, *Recognition of States in International Law*, 53 *THE YALE LAW JOURNAL*, 385-458 (1944).

<sup>32</sup> LASSA OPPENHEIM, *INTERNATIONAL LAW: A TREATISE, VOLUME 1 PEACE* 119 (1905).

considerable discretion of other states. This position delegitimises the criteria given in the Montevideo Convention. Considering the principles of equity and justice, an entity that fulfils the conditions of statehood cannot, because of a lack of recognition, be denied its right or escape its obligations.<sup>33</sup> Non-recognition would also justify and license invasions without legal responsibility. The theory also questions the ethical dimensions of international laws, as non-recognition of a state means that the citizens of that state may not be protected by international law, either in war or in peace.

The opposing idea to this line of thought is the “declaratory” theory. Clarifying the academic dilemma and distinctiveness of these approaches to recognition, Malcolm Shaw in his seminal work remarked, “For the constitutive theorist, the heart of the matter is that fundamentally an unrecognized ‘state’ can have no rights or obligations in international law... and declaratory approach that emphasizes the factual situation and minimizes the power of states to confer legal personality.”<sup>34</sup>

Despite the long list of classical works and influential jurists supporting the constitutive theory, the theory due to its inherent drawbacks is considered unacceptable. Declaratory theory, on the other hand, finds support from thinkers like Brierly,<sup>35</sup> Moore<sup>36</sup> and Briggs.<sup>37</sup> According to this theory, the rights and attributes of sovereignty belong to it independently of all recognition, but it is only after it has been recognized that it is assured of exercising them.<sup>38</sup> When a state fulfils the fundamental elements and objective

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<sup>33</sup> LOUIS HENKINET AL, *INTERNATIONAL LAW: CASES AND MATERIALS (AMERICAN CASEBOOK SERIES)* 171 (5th Ed., 2009).

<sup>34</sup> MALCOLM N. SHAW, *INTERNATIONAL LAW* 446 (6th Ed., 2008).

<sup>35</sup> J BRIERLY, *THE LAW OF NATIONS* 138 (1963)

<sup>36</sup> MOORE, *A DIGEST OF INTERNATIONAL LAW* 72-74 (1906).

<sup>37</sup> Fred L. Morrison, *Recognition in International Law: A Functional Reappraisal*, 34 *THE UNIVERSITY OF CHICAGO LAW REVIEW*, 861 (1967).

<sup>38</sup> I MOORE, *A DIGEST OF INTERNATIONAL LAW* 72 (1906).

standards of statehood, it automatically becomes subject to the rights and duties of international law. This theory closely resembles the Estrada Doctrine of Recognition, named after Don Genero Estrada, the Mexican Secretary of Foreign Affairs. Responding to repeated interference by the United States in Latin American affairs, he stated, through a policy of selective recognition, that his government and Mexican diplomats should not issue declarations that amounted to a grant of recognition as he was of the view that this was an insulting practice and offensive against the sovereignty of other nations.<sup>39</sup> The doctrine therefore states that recognition of a government should be based on its *de facto* existence, rather than on its legitimacy. In the 1980s, many European and American states adopted the Estrada doctrine.<sup>40</sup>

The declaratory position on recognition also finds support in the opinions of the Arbitration Commission of the Hague Conference on Yugoslavia, which was set up with the backing of the European Political Co-operation (EPC). In its opinion dated 29 November 1991, the commission stipulated that:

*“The principles of public international law...serve to define the conditions on which an entity constitutes a State; that is in this respect, the existence of the State is a question of fact; that the effect of recognition by other States are purely declaratory.”*<sup>41</sup>

The constitutive theory promotes subjugation of *jus cogens* principles in the modern international law regime like sovereignty and denial of justice. The constitutive theory promotes the illegal

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<sup>39</sup> BARRY E. CARTER & ALLEN S. WEINER, INTERNATIONAL LAW 439 (2014).

<sup>40</sup> MARTIN DIXON, TEXTBOOK ON INTERNATIONAL LAW 138 (2013).

<sup>41</sup> Opinion No. I, 201 [Disintegration] (1991) 92 ILR 162; Affirmed in Opinion No. 8 [Extinction] (1992) ILR 199.

and illegitimate creation of states<sup>42</sup> and the essence of illegality derelicts *jus cogens* principle of ethical state action in international law.<sup>43</sup> History of State practice bespeaks that an “unrecognized State” is also bound by international law. One such example is the shooting down of a British fighter jet by Israeli armed forces in 1949, and the consequent holding of Israel to legal responsibility – despite not being recognised at the time by the United Kingdom due to its reliance on the constitutive interpretation of recognition<sup>44</sup>. Another example could be of the Arab States, which have not formally recognized Israel as a State, but continue to condemn Israel for not adhering to international obligations.<sup>46</sup>

Some contemporary thinkers have suggested creating a middle ground by combining the best practices of both these approaches. According to Lauterpacht, the process of recognition starts from a constitutive basis but then imposes a duty upon each of the pre-existing states to grant recognition to a new community once it has satisfied certain objective criteria, thus importing a declaratory element.<sup>47</sup> As per State practice, recognition does not create a State, it only acknowledges its existence.<sup>48</sup>

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<sup>42</sup> Jure Vidmar, *Explaining the legal effects of Recognition*, 61 THE INTERNATIONAL AND COMPARATIVE LAW QUARTERLY 2, 361-387 (2012).

<sup>43</sup> CRAWFORD, THE CREATION OF STATES IN INTERNATIONAL LAW 48 (1987)

<sup>44</sup> Zeev Tzahor, *The 1949 Air Clash between the Israeli Air Force and the RAF*, 28 JOURNAL OF CONTEMPORARY HISTORY, 75-101 (1993).

<sup>45</sup> See Israel (Attacked British Aircraft), HC Deb 11 May 1949 Vol 464 Commons Sitting 1822-4, PARLIAMENT OF UK, May 11, 1949, <https://api.parliament.uk/historic-hansard/commons/1949/may/11/israel-attacked-british-aircraft>.

<sup>46</sup> Arab nations condemn Netanyahu's Jordan Valley annexation plan, BBC NEWS, Sep. 11, 2019 (Apr. 9, 2020, 7.30 PM) <https://www.bbc.com/news/world-middle-east-49657915>.

<sup>47</sup> Cf. LAUTERPACHT-OPPENHEIM, INTERNATIONAL LAW 120-46 (6th ed., 1947).

<sup>48</sup> See Application for Revision of the Judgment of 11 July 1996 in the Case concerning Application of the Convention on the Prevention and Punishment of



*B. The shift in discourse: From “isolation” to “cooperation and common future”*

The ideal need (and goal) for the recognition of states was to promote peace, stability and human rights in the international community, but the rules of the international community influence decisions to give primacy to balance of power. The fall of two movements - Cold War and Communism, gave impetus to a new wave of state-formation in the European region. And the era post the Second World War gave impetus to the decolonisation process in the Asian and African region. Both these factors, coupled with the establishment of the United Nations, heralded a new dawn for modern international law principles. Article 2(1) of the United Nations Charter stipulates, “....self-determination of peoples, and to take other appropriate measures to strengthen universal peace.” The ‘right to self-determination’ forms the very base of new approaches to international law.<sup>49</sup>

Although the Catalan declaration received no recognition from the international community, the effectiveness of the post-United Nations model of self-determination leading to state recognition remains relevant even in today’s era. A contextual analysis of recognition shows that recognition has twin dynamics. For those who are aspiring it, recognition represents *a jus cogens* right for survival, and to those granting it, recognition is a matter of political

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the Crime of Genocide (Bosnia and Herzegovina v. Yugoslavia), Preliminary Objections (Yugoslavia v. Bosnia and Herzegovina).

<sup>49</sup> See also the application of self determination of the 2017 Catalan declaration of independence, which declared the independence of Catalonia from Spain. See Raphael Minder & Patrick Kingsley, *In Catalonia, a Declaration of Independence from Spain (Sort of)*, N.Y. TIMES, Oct.10, 2017, <https://www.nytimes.com/2017/10/10/world/europe/spain-catalonia-independence-carles-puigdemont.html>.

evaluation and discretion.<sup>50</sup> It makes recognition one of the most controversial subjects of international law as the legal principle is ultimately a result of the political evaluation and political interests. Recognition thus became a matter of *Realpolitik*<sup>51</sup> since State practice tends to show that the 'will and consent' of other States gained prominence over the objective elements.

The function of law must evolve with changing realities. The establishment of the United Nations in the aftermath of the horrors of World War II was a universal effort to prevent the recurrence of wars and protect human rights.<sup>52</sup> The establishment can also be viewed as an effort to crystallize collective recognition of states to ensure the stability of the international order. The Preamble to the UN Charter read with the objective of United Nations also converge to meet the ends "to practice tolerance and live together in peace with one another as good neighbours", and "to unite our strength to maintain international peace and security". The Preamble to the UN Charter seeks to ensure by the acceptance of principles and the institution of methods, that armed force shall not be used, except in the common interest.

Membership in the United Nations is regulated by Article 3 of the Charter. Article 3, interestingly, refers to "the original Members".<sup>53</sup>

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<sup>50</sup> Ermira Mehmeti, *Recognition in International Law: Recognition of States and European Integration - Legal and Political Considerations*, 2 EUROPEAN JOURNAL OF INTERDISCIPLINARY STUDIES, 247 (2016).

<sup>51</sup> Realpolitik holds that "political ideas, and associated political discourse are based on practical rather than moral or ideological considerations". Henry C. Emery, *What is Realpolitik?*, 25 INTERNATIONAL JOURNAL OF ETHICS 4 (1915); Otto Pflanze, *Bismarck's Realpolitik*, 20 THE REVIEW OF POLITICS 4, 492-514 (1958).

<sup>52</sup> The Formation of the United Nations, 1945, Office of the Historian, DEPARTMENT OF STATE - UNITED STATES OF AMERICA (Apr. 9, 2020, 7.30 PM), <https://history.state.gov/milestones/1937-1945/un>.

<sup>53</sup> UN CHARTER. Art. 3. It reads: "The original Members of the United Nations shall be the states which, having participated in the United Nations Conference on International Organization at San Francisco, or having previously signed the

It is noteworthy to understand that during the initial decade of the United Nations regime, most of the original members had been recognized as states; however, there were few states,<sup>54</sup> which at the time of admission had not been fully independent. Article 4 describes the procedure for the admission of new Members. Article 4(1) states that “Membership in the United Nations is open to all other peace-loving states which accept the obligations contained in the present Charter.” Furthermore, Article 4(2) states the admission of any such state to membership in the United Nations.<sup>55</sup> It is interesting to note that the UN Charter speaks about “admission” expressly, and not recognition. It can also be seen as creating further ambiguity as indicating that the organization does not deal with the objective evaluation of the fulfilment of the Montevideo criteria. This idea of an international organisation extending collective recognition has fewer proponents because a member-state may vote in favour of granting recognition to a State in the United Nations, but continue to not exercise diplomatic and political relations with it.

### III. RECONCEPTUALIZING RULE OF LAW IN RECOGNITION OF STATES

The role of international law in ensuring international cooperation is indispensable. The idea of statehood through self-determination is a national idea. This view was also reflected in the American Declaration of Independence in 1776 and the French Revolution in 1789. Article 7 of the Montevideo Convention on the Rights and Duties of States provides that, “the recognition of a state may be express or tacit.”

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Declaration by United Nations of January 1, 1942, sign the present Charter and ratify it in accordance with Article 110.”

<sup>54</sup> See, Original members which were not sovereign when they joined the UN, and only gained full independence later are Belarus, India, Philippines and New Zealand, among other.

<sup>55</sup> UN CHARTER. art. 18, cl. 2.

H. Lauterpacht drew an analogy between recognition and the place of war in international law by remarking:

*"[T]he legal admissibility of war showed how unreal was the borderline between law and lawlessness, between the duty to let live and the right to extinguish. It showed that law obtained only so long as States were willing to tolerate it and that it was left to them to divest themselves of the most fundamental of all duties by one legally authorized arbitrary act."*<sup>56</sup>

Recognition as a formal method to identify state actors ensures cooperation and has a direct implication for the rights, obligations, powers, and immunities in which the international legal order trades. According to Axel Honneth:

*"[e]ven distributional injustices must be understood as the institutional expression of social disrespect or, better said, of unjustified relations of recognition."*<sup>57</sup>

The principle of self-determination of peoples lay at the core of the recognition of states. The ideals of this model of sovereignty date back to Woodrow Wilson's Fourteen Points and the rise of nationalism as a socio-political phenomenon.<sup>58</sup>

Rule of law in global governance ensures certainty, stability and procedural equity. But the history of State recognition shows that these principles are seldom adopted in practice. A perfect example of diversion from these core ideals is the case of Southern Rhodesia.

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<sup>56</sup> H. Lauterpacht, *Recognition of States in International Law*, 53 THE YALE LAW JOURNAL 388 (1944).

<sup>57</sup> BRAD R. ROTH, RECOGNITION IN INTERNATIONAL RELATIONS: RETHINKING A POLITICAL CONCEPT IN A GLOBAL CONTEXT 141 (Daase C. Eds., 2015).

<sup>58</sup> See *The war of the nations: portfolio in rotogravure etchings: compiled from the Mid-week pictorial*, (New York United States) 1 Jan. 1919, THE LIBRARY OF CONGRESS (Apr. 9, 2020, 7.30 PM), [www.loc.gov/item/19013740/](http://www.loc.gov/item/19013740/).

The colony of Southern Rhodesia was a self-governing British territory for 42 years. Established in 1923, when the territory fulfilled all the essential elements of statehood, it declared itself as an independent sovereign state in 1965.<sup>59</sup> Nonetheless, the community was never recognized *de jure* as an independent State. Non-recognition was justified as the government in power was white-dominated, despite them being in the racial minority. The UN Security Council Resolution 216 condemned the South Rhodesian Declaration of Independence 'made by a racist minority' and called upon all other member States to refuse recognition of Southern Rhodesia.<sup>60</sup> This shows that State recognition is subject to discretionary policies and discretionary justifications and is not a result of an exclusively objective legal examination of whether or not an entity meets the criteria for Statehood.

The core theme of multilateralism is to ensure that states are bound by rules and rules are applied irrespective of power dominance. Recognition as a conceptual theory is proof of two non-idealistic truths: first, political arguments prevail over legal arguments in international law; and second, there can be no single formula or a set of universal principles that can be applied when we delve into recognition patterns. Discretion and rule of law seldom go together. This quotient of 'arbitrariness' in recognition can also be sensed in the politics revolving around Kosovo's independence.<sup>61</sup> After the infamous Cold War when Kosovo declared itself

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<sup>59</sup> Andre Holt, *Southern Rhodesia's Unilateral Declaration of Independence (UDI)*, THE NATIONAL ARCHIVES (Apr. 9, 2020, 7.30 PM), <https://blog.nationalarchives.gov.uk/southern-rhodesias-unilateral-declaration-independence-udi/>.

<sup>60</sup> See, S.C. Res. 216 (1965) (Nov 12, 1965).

<sup>61</sup> Ronald Thomas, *The Distinct Cases of Kosovo and South Ossetia: Deciding the Question of Independence on the Merits and International Law*, 32 FORDHAM INTERNATIONAL LAW JOURNAL, 1990 (2008).

independent,<sup>62</sup> Russia refused to recognize it on grounds that it was 'illegal', that it constituted a breach of international law and hence, represented a dangerous precedent.<sup>63</sup> But immediately after few months of taking this ethical diplomatic position, when the South Ossetian (Georgian) War broke out and South Ossetia and Abkhazia declared independence, Russia was the first country to recognize the independence of these newly formed Georgian provinces.<sup>64</sup>

The whole notion of 'breach of norms of international law' or 'dangerous precedents' found a place that was quite invisible in its diplomatic response. Furthermore, then Russian President Dmitry Medvedev called upon other countries to follow its example.<sup>65</sup> These are shreds of evidence of the fact that recognition is subject to discretionary policies and relations between states, and not a result of an exclusively objective legal examination of whether or not an entity meets the criteria for Statehood – and the existence of arbitrariness is the absence of rule of law.

#### *A. Recognition: How it works in practice?*

Recognition is typically a unilateral diplomatic action of the States. These acts lead to two events. First, the carving out of statehood and second, the crystallisation of its sovereignty, making the State a legal entity. During World War I, Great Britain, France and the United States and other powers recognized Poland and Czechoslovakia before their formalisation as independent States or

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<sup>62</sup>See, Full text: Kosovo declaration, BBC NEWS (Feb 17, 2008), <http://news.bbc.co.uk/2/hi/europe/7249677.stm>.

<sup>63</sup> Christopher J. Borgen, *Kosovo's Declaration of Independence: Self-Determination, Secession and Recognition*, ASIL (Feb 29, 2008), <https://www.asil.org/insights/volume/12/issue/2/kosovos-declaration-independence-self-determination-secession-and>.

<sup>64</sup> Clifford J. Levy, *Russia Backs Independence of Georgian Enclaves*, N.Y. TIMES, Aug. 26, 2008, <https://www.nytimes.com/2008/08/27/world/europe/27russia.html>.

<sup>65</sup> Medvedev's Statement on South Ossetia and Abkhazia, N.Y. TIMES, Aug. 26, 2008, <https://www.nytimes.com/2008/08/27/world/europe/27medvedev.html>.

governments.<sup>66</sup> Although elements such as territory are carved out as essential for a state under the Montevideo Convention, these are not absolute. For example, when United States President Harry Truman recognized the provisional Jewish government as the *de facto* authority of Israel, its boundaries were not fully determined. In practice, recognition is a decision taken in pursuance of national interest and may either be *de facto* or *de jure*. In *de jure* recognition, the State recognized formally fulfils the essential requirements for participation in the international community. *De facto* recognition is a result of a hesitant assessment of circumstances and indicates a provisional recognition with reservations for the future. For example, the United Kingdom recognized the Soviet Government *de facto* in 1921 and *de jure* in 1924.<sup>67</sup>

Article 7 of the Montevideo Convention provides that “the recognition of a state may be express or tacit.” International law has also seen States granting recognition to states or secessionist communities before they have gained political stability or permanence. For example, India recognized Bangladesh before it gained permanence. Premature recognition is a form of unlawful intervention<sup>68</sup> by denying the sovereignty of the parent State actively engaged in asserting its authority.<sup>69</sup> According to Hans Kelsen, “premature recognition of revolting insurgents is an offense to the parent state and therefore violative of international law.”<sup>70</sup>

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<sup>66</sup> UNITED STATES CONGRESS, CONGRESSIONAL RECORD: PROCEEDINGS AND DEBATES OF THE CONGRESS, No. 178-82 Vol. 108, at 21386 (1962).

<sup>67</sup> George Grafton Wilson, *British Recognition de Facto and de Jure of the U. S. S. R.*, 28 THE AMERICAN JOURNAL OF INTERNATIONAL LAW, 99-101 (1934).

<sup>68</sup> See Daniel L. Cruise, *The Premature Recognition of Bosnia-Herzegovina : Letters from Javier Pérez de Cuéllar*, 1 THE BROWN JOURNAL OF FOREIGN AFFAIRS 1, 133-144 (1994)

<sup>69</sup> H. Lauterpacht, *Recognition of States in International Law*, 53 THE YALE LAW JOURNAL, 392 (1944).

<sup>70</sup> Edwin Borchard, *Recognition and Non-Recognition*, 36 THE AMERICAN JOURNAL OF INTERNATIONAL LAW 1, 108-111 (1942).

A political recognition in practice can also be conditional, e.g. the United States recognized the Soviet Government on the condition that the latter would not indulge in activities prejudicial to the internal security of the United States.<sup>71</sup> Recognition is a political act and policies of non-recognition turn out to be examples of political non-recognition of the kind Arbitral Taft had to deal with in the Tinoco Concessions Case.<sup>72</sup> In the case concerning the validity of the oil concessions granted under Tinoco to British Owned Oil Fields through the Central Costa Rican Petroleum Company, it was held that the “principle of peaceful de facto administration and the non-recognition of the government by other government does not destroy the de facto status of the government.”<sup>73</sup>

Recognition empowers a state to conclude treaties, establish diplomatic relations, ensures immunity of legal persons and enables the state to sue in international courts. However, there have been exceptions as well. For example, the United Kingdom treated the German Democratic Republic as bound by its signature<sup>74</sup> of the 1963 Nuclear Test Ban Treaty<sup>75</sup> even when the state was not recognized by the UK.<sup>76</sup>

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<sup>71</sup> Foreign Relations of the United States, 1955–1957, Soviet Union, Eastern Mediterranean, Volume XXIV, 94. National Security Council Report, Mar. 26, 1955, Office of the Historian, DEPARTMENT OF STATE - UNITED STATES OF AMERICA (Apr. 9, 2020, 7:30 PM),

<https://history.state.gov/historicaldocuments/frus1955-57v24/d94>.

<sup>72</sup> See Tinoco Claims Arbitration (*Great Britain v. Costa Rica*), 1 U.N. Rep. Int'l Arb. Awards 369 (1923).

<sup>73</sup> *Id.*

<sup>74</sup> THOMAS SCHMALBERGER, IN PURSUIT OF A NUCLEAR TEST BAN TREATY: A GUIDE TO THE DEBATE IN THE CONFERENCE ON DISARMAMENT 69 (1991).

<sup>75</sup> Egon Schwelb, *The Nuclear Test Ban Treaty and International Law*, 58 THE AMERICAN JOURNAL OF INTERNATIONAL LAW 3, 642-70 (1964).

<sup>76</sup> MALCOLM N. SHAW, INTERNATIONAL LAW 471 (6th Ed., 2008).



### *B. Recognition of State, Not Government*

Recognition of Government and Recognition of State are two distinct cases of recognition. A Government is a medium through which a State represents itself. For H. Lauterpacht,

*“to decline to recognize the government of a State is to refuse, to a substantial extent, to recognize the State itself and to accord it what is its due in the international sphere.”*<sup>77</sup>

Denial to recognize the Government is also the denial to recognize the legislative, judicial, and administrative acts of the State. But the real issue arises when there is a revolutionary government representing a State against an existing government. In cases like insurgency or belligerence, what is to be considered by the International Community is the factor of ‘effective control’. Recognition may be of a *de facto* government in effective control of only part of the territory of the state in question.<sup>78</sup> The controversial status of Taiwan can be considered as an example. Since the Republic of China’s (ROC/Taiwan) lost its United Nations seat to the People’s Republic of China (PRC), most sovereign states, except 14 UN Member States have switched their diplomatic recognition to the PRC. Although, Government of ROC informally maintains relations with nearly all others.<sup>79</sup> There is also a view which says that the “capacity to enter into relations with States” is not the exclusive entitlement of States considering the changing character of Law of Nations.<sup>80</sup> It is noteworthy to mention that there is no evidence to

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<sup>77</sup> H. Lauterpacht, *Recognition of States in International Law*, 53 THE YALE LAW JOURNAL 389 (1944).

<sup>78</sup> MALCOLM N. SHAW, *INTERNATIONAL LAW* 445 (6th Ed., 2008).

<sup>79</sup> Chris Horton, *Taiwan’s Status Is a Geopolitical Absurdity*, THE ATLANTIC, Jul. 8, 2019, <https://www.theatlantic.com/international/archive/2019/07/taiwans-status-geopolitical-absurdity/593371/>.

<sup>80</sup> J. Crawford, *The Criteria for Statehood in International Law*, 48 BRITISH YEARBOOK OF INTERNATIONAL LAW 119 (1977)

indicate that states regard unrecognized states as *terra nullius*.<sup>81</sup> This approach opines that autonomous national authorities, liberation movements<sup>82</sup> and insurgents are all diplomatically capable of maintaining relations with States and other institutions of international law.<sup>83</sup>

### *C. Political recognition and diplomatic recognition*

Governments have recognized statehood by using policy preferences, non-legal considerations, future benefits, quid pro quo and even sociological factors. In the words of Michael Field:

*“Foreign policy decision-makers have utilized recognition in myriad ways, depending on the political circumstances of the time and their perception of the national interests involved in a change of government. Thus, for example, the United States has used recognition as a political tool to support antimonarchical governments (under George Washington), to advance economic imperialism (under Theodore Roosevelt), to promote constitutional government (under Woodrow Wilson), and to halt the spread of communism (under*

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<sup>81</sup> *Terra nullius* i.e. nobody’s land is a Latin expression used to justify claims that territory may be acquired by a state’s occupation of it. William Thomas Worster, *Law, Politics, and the Conception of the State in State Recognition Theory*, 27 BOSTON UNIVERSITY INTERNATIONAL LAW JOURNAL 119 (2009).

<sup>82</sup> Natalino Ronzitti, *Resort to Force in Wars of National Liberation*, in CURRENT PROBLEMS OF INTERNATIONAL LAW: ESSAYS ON U.N. LAW AND ON THE LAW OF ARMED CONFLICT 319, 338 (Antonio Cassese ed., 1975). See also *Knox v. Palestine Liberation Organization*, 306 F.Supp.2d 437 (S.D.N.Y. 2004), “it would be anomalous indeed to hold that a state may achieve sufficient independence and statehood in the first instance while subject to and laboring under the hostile military occupation of a separate sovereign.”

<sup>83</sup> James Crawford, *The Criteria for Statehood in International Law*, 48 BRITISH YEARBOOK OF INTERNATIONAL LAW, 119 (1976).

*Dwight Eisenhower*). *The practice of other states is similarly diverse.*"<sup>84</sup>

Recognition once granted cannot be revoked. Recognition of a state undoubtedly signifies acceptance by one state of another into the legal framework of international law. As the nature of communities' change, it has a direct reflection on the nature of government administering the state. Situations that alter the national identity of a state from the time it was identified, requires the practical theory of international law to differentiate between "diplomatic recognition" and "political recognition." Recognition of government is a legal cognizance of it as the administering authority or agent of that state.

With the rise of democracies, post the World War II era, recognition of a democratically elected government is acknowledged as a representative agent of the people of that state. On the other hand, the establishment of diplomatic relations is only the creation of formal means of communication between the governments of two states.<sup>85</sup> It means that a state can politically acknowledge another state, but it can choose not to enter into diplomatic intercourse with it. Abstention from diplomatic recognition may imply the political impossibility to enter into diplomatic relations, but it need not imply non-recognition of its legal identity.

Diplomacy in this sense is like tracing directions in the ocean – without a compass, one can head nowhere. In case of rapidly changing national political climates and policymaking directly affecting its international policies: if there is a continuity of personnel

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<sup>84</sup> Michael E. Field, *Liberia v. Bickford: The Continuing Problem of Recognition of Governments and Civil Litigation in the United States*, 18 MD. J. INT'L L. & TRADE 113 (1994).

<sup>85</sup> Fred L. Morrison, *Recognition in International Law: A Functional Reappraisal*, 34 THE UNIVERSITY OF CHICAGO LAW REVIEW 870 (1967).

administering the states involved, governmental recognition continues.

In today's interdependent world, in international relations, one is either at the table or on the menu. It makes it practically impossible for most states to survive without entering into diplomatic relations with others. With the emergence of the United Nations as an institutional body administering treaties and national blocs coming together for geopolitical economics, diplomatic recognition has become a living necessity.

#### IV. INDIAN APPROACHES TO RECOGNITION

With the end of colonisation, the character of international law as a stigmatising weapon to enforce eurocentrism also changed. Many TWAIL thinkers are still of the opinion<sup>86</sup> that colonisation has not ended, but has merely changed its character. The newly independent states made it clear that colonialism in all manifestations is evil and whatever its validity under traditional European international law cannot be accepted.<sup>87</sup> In 1960, the General Assembly of the United Nations declared that "all peoples have an inalienable right to complete freedom".<sup>88</sup> The new majority formed demanded that international law must change with the changing global order, and this desire of the third world influenced the political decisions and patterns of geopolitical shifts.

Prime Minister Jawaharlal Nehru lead a newly independent India towards a policy of favouring the independence and recognition of Asian and African countries that recently emerged from the shackles of colonialism, as soon as it became clear that they

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<sup>86</sup> Makau Mutua and Antony Anghie, *What Is TWAIL?* 94 PROCEEDINGS OF THE ANNUAL MEETING (AMERICAN SOCIETY OF INTERNATIONAL LAW) 31-40 (2000).

<sup>87</sup> R.P. ANAND, DEVELOPMENT OF MODERN INTERNATIONAL LAW AND INDIA 107 (2005).

<sup>88</sup> G.A. Res. 1514 (XV) (Dec. 14, 1960).

were independent entities, and had attained permanence of territory and stability of the government.<sup>89</sup>

R.P Anand argues that Asian countries had suffered during the pre-United Nations era because of the non-recognition of Asian states as members of the international community.<sup>90</sup> These horrors of the past have influenced how Asian countries have favoured independence. India's recognition in the cases of China, Israel, Spain and Vietnam and the general policy adopted in the late 1990s subscribed "to the principle of *de facto-ism*, even if it was at the risk of some misunderstanding or alienating the sympathies of her best friends".<sup>91</sup> India recognized the Communist Chinese Government as soon as it became evident that "the new Chinese Government controlled practically the entire mainland of China, and when it was quite clear that this Government was stable."<sup>92</sup> In 1948, India recognized Israel as an independent state at the risk of irritating her Arab allies; notably, however, the Indian Government deferred the establishment of diplomatic relations with the new state.

The ultimate purpose of any country's foreign policy is to promote the security and well-being of its own citizens.<sup>93</sup> India as an emerging player in geo-economics wants a world that gives it the conditions of peace and security that would permit it to grow and flourish - safe from foreign depredations, but open to external opportunities.<sup>94</sup> This perspective to approach international relations

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<sup>89</sup> R.P. ANAND, *supra* note 90, at 114

<sup>90</sup> R.P. ANAND, *STUDIES IN INTERNATIONAL LAW AND HISTORY: AN ASIAN PERSPECTIVE* 17 (2013).

<sup>91</sup> KP Mishra, *India' Policy of Recognition of States and Governments*, *AMERICAN JOURNAL OF INTERNATIONAL LAW* 408 (1961).

<sup>92</sup> See, N. V. K. Murthy, *Recognition of Communist China Under International Law with Special Reference to the Policies of Great Britain, U. S. and India*, 20 *THE INDIAN JOURNAL OF POLITICAL SCIENCE*, 135-40 (1959).

<sup>93</sup> SHASHI THAROOR & SAMIR SARAN, *THE NEW WORLD DISORDER AND THE INDIAN IMPERATIVE* 9 (2020).

<sup>94</sup> *Id.*

has also trickled down to its actions of recognition. The Indian Government too, with its emergence as a leading player in South Asia, has departed from traditional principles to adopt geo-strategic responses. Shifting patterns of India's core ideology was seen when India recognized Bangladesh in 1971. India's policy on Tibet is a clear example of geostrategic pragmatism and soft power. In today's Machiavellian era, no nation would succumb to ethical dimensions when abidance with such higher values would destruct the flow of its domestic policies.

Post-1990s, India is no longer facing the same challenges of bipolar world order. India is exerting its dominance in the South Asian region as a parallel leader to China with its space diplomacy and economic restructuring. The changes in the Indian Ocean diplomacy also reflects how the landscape of geopolitics has shifted from a sympathising role to a subaltern protagonist. Indian civilisation is rooted in its cultural diversity and ethnic pluralism. Any approaches to the practice of laws must reflect the cultural traditions of the nation. While the debate surrounding recognition of States is an effort by the civil community to infuse rule of law principles in political actions taken by the Government, Indian civilisation must try to reflect its civilisational principles in foreign policy actions. While India's *Panchsheel* doctrine is considered to be a perfect exemplar for the TWAIL world, Vedic history opens doors to various other diplomatic principles. From the perspectives of human history, the colonial epoch cannot be carry forwarded as a civilising mission even today. The development of international politics and economic organisations should move away from the ideals of eurocentrism.

Kautilya's *Arthashastra* is easily the most outstanding work illustrating the fidelity of Kautilyan prescriptions of statecraft. Kautilya was the first 'Contractualist' in India, however, his idea of

a social contract was different from the Hobbesian perspective. According to Kautilya, an area cannot be a State unless there are people and people have rulers to administer the State.<sup>95</sup> The administration of State for Kautilya should be Dharmic. Even today, this principle of Dharma based responses can be reflected in the diplomatic decisions taken by the State. While Kautilya's *Arthashastra* is the most widely cited work in India's contribution to international politics, Vedic literature still remains an unexplored ocean. Ancient works like *Kamandaka Niti* expounds on various principles on State policy and diplomatic responses. Schools of thought like the *Sukracharya* School of Governance and *Brihaspati* School of Governance are perfect examples of how political actions by the state should promote societal (both national and transnational) peace and security of the people. Indian schools of governance are based on four knowledge: *Dhandneethihi* (rule of law and enforcement of contracts); *Vartha* (economic policy); *Trayi* (cultural roots) and *Anvikshiki* (philosophical principles). India's justifications for recognition or non-recognition must reflect these core principles which made ancient India one of the most influential civilisations in the world. These core principles should merge to form the centrality of the ethical and political decision of the State to justify recognition or non-recognition. Principles of recognition have the potential to translate these high philosophic concepts into the world of accessible policy and practices.<sup>96</sup>

#### V. "FWAIL-IAN" CALL FOR RECOGNITION

Classical international law laid down a Euro-American 'civilized standard' to measure any people looking to become a subject of

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<sup>95</sup> Ram Ranbir Singh, *Kautilya's conception of State*, 65 THE INDIAN JOURNAL OF POLITICAL SCIENCE 43-52 (2004).

<sup>96</sup> Cf. B.S. Chimni, *The Self, Modern Civilization, and International Law: Learning from Mohandas Karamchand Gandhi's Hind Swaraj or Indian Home Rule*, 23 EUROPEAN JOURNAL OF INTERNATIONAL LAW 4, 159-1173 (2012).

international law. The new journey of international law is an attempt to break the barriers and redefining the parameters of civilized standard. In post-modern international legal philosophy, recognition of other identities is an outcome of acknowledgement of diversity and multiculturalism. Recognition as a global phenomenon has never remained uniform in practice. Twenty-first century legal systems are facing an invisible problem of an identity crisis. Recognition can also be seen as an endeavour to reconstruct a 'narrative identity'. The fourth world approaches to international law (FWAIL) is a political-legal movement in this direction.

FWAILIAN approach is a living revolution. A revolution of a community of indigenous people descended from a common nation of aboriginal populations who have been deprived of their territory and political rights, such as many indigenous people currently struggling for their independence in multiple regions in Asia.<sup>97</sup> FWAIL attempts to give active voice to victims of predatory policies of the state system and international law. It is documented that there are around 400 "legally" recognized indigenous nations exist within and around the 48 contiguous US state borders because of their signed and ratified treaties with the US government.<sup>98</sup> These indigenous communities are struggling to voice their right to legal recognition of their "nationhood" status under international law. FWAIL also attempts to redefine "Democratic sovereignty" and "cultural implications". The school of legal thought advances that "democratic entitlement" of the right of self-determination of

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<sup>97</sup> Hiroshi Fukurai, *Fourth World Approaches to International Law (FWAIL) and Asia's Indigenous Struggles and Quests for Recognition under International Law*, 5 ASIAN JOURNAL OF LAW AND SOCIETY 224 (2018).

<sup>98</sup> *Presidential Address at 2017 Annual Conference of the Asian Law and Society Association (ALSA)* in Hiroshi Fukurai, *Fourth World Approaches to International Law (FWAIL) and Asia's Indigenous Struggles and Quests for Recognition under International Law*, 5 ASIAN JOURNAL OF LAW AND SOCIETY 226 (2018).



peoples logically leads to the right to democracy within states.<sup>99</sup> A close analysis of this model also suggests an inquisitive question: – Whether self-determination in itself as a universal right is a luxury?

## VI. CONCLUSION

One vision of law is that international law consists of responses to social events, reflects social power, and precisely there makes its unique contribution to the ordering of human affairs.<sup>100</sup> And the role of the State to ensure a social balance of power is pre-eminent. With the rise of ‘democracy’ as a new universalistic political philosophy, the gap and difference of recognising States and Governments are widening. The democratic States tend to promote democracy in other States to ensure democratic legitimacy as a factor in recognition. In today’s multi-dimensional world ‘democratic legitimacy’ should not serve as a straitjacket for governments and States should allow on a case-by-case basis, governments to develop and adopt practices that promote the welfare of its people.<sup>101</sup>

The state by its very creation has a monopoly over violence, and recognition of State is an effort to reorganize and restructure its rights and obligations under international law for ensuring global peace. Using the notion of “sovereignty” as a justification to grant recognition also props up a new dilemma. As recognition of sovereignty is a *jus cogens* principle that cannot be denied for the state seeking recognition, sovereignty also means that discretion of the State granting recognition cannot be influenced or intervened under the guise of equality. There is enough literature to prove that in international relations, recognition is a politicized law arising out

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<sup>99</sup> JANNE HAALAND MATLARY, A RETURN TO MULTIPOLARITY AND REALPOLITIK? HUMAN RIGHTS UNDER PRESSURE 215 (2013).

<sup>100</sup> Martti Koskenniemi, *The Wonderful Artificiality of States*, 88 AM. SOC’Y INT’L L. PROC. 22, 23-24 (1994).

<sup>101</sup> Sean D. Murphy, *Democratic Legitimacy and the Recognition of States and Governments*, 48 INTERNATIONAL AND COMPARATIVE LAW QUARTERLY 581 (1999).

of legalized politics. The alternative to the existing theory to balance these equations of 'law' and 'politics' is that the state's unlimited discretion to recognize a new state must be limited. Violation of the rule of law is a threat to the security of international order and unlimited discretion is arbitrariness, and it reflects the withering away of the essence of the rule of law. Stability and certainty in international law demand a certain degree of consistency rather than opportunism. To dig into recognition, we need an interdisciplinary analysis of various subjects from geography to political science, law to diplomacy, national legal system to international legal system, and an alternative approach has to acknowledge the multidimensional ethical dilemmas. As Kelsen said:

*"[T]he problem of recognition of states and governments has neither in theory nor in practice been solved satisfactorily. Hardly any other question is more controversial, or leads in the practice of states to such paradoxical situations."*<sup>102</sup>

On the conceptual level, state practice reveals the complexities surrounding self-determination and its relation to the principle of territorial integrity. The ambiguities in the existing framework cannot be solved using absolute legal principles. The reformation of the system requires the coexistence of developmental politics and developmental law. Balance of power is a journey and coherence between the natural relationship between law and politics is the ultimate end of international law.

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<sup>102</sup> Hans Kelsen, *Recognition in International Law: Theoretical Observations*, 35 AJIL 605, 605 (1941).

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**THE INDIAN MUTUAL FUND INDUSTRY: REGULATORY  
EVOLUTION AND THE CONTEMPORARY CHINKS IN THE  
ARMOUR VIS-À-VIS CRISES LIKE FRANKLIN TEMPLETON  
2020**

- **Jessica Kaur\***, **Srishti Kaushal\***

**ABSTRACT**

*Since its inception in 1963, the mutual fund industry in India has evolved significantly. Consequently, with the Securities and Exchange Board of India (SEBI) introducing new regulations and amending the existing ones to meet the needs of the changing times, the industry's regulatory framework has also become increasingly sophisticated. However, despite the extensive legal framework, this sector of the economy has witnessed numerous financial crises in recent years, especially in the debt MF segment - with the latest being the sudden winding-up of six Franklin Templeton schemes in 2020. Such crises usher in massive losses for the investors and adversely affect the stability of the industry as a whole. Thus, it becomes increasingly crucial to understand the reasons which lead to such situations and undertake steps to prevent them in the future. The objective of this research, thus, is to study the regulatory evolution of the mutual fund industry over the years, analyse the reasons which led to the winding-up of the Franklin Templeton schemes, and examine whether any loopholes still prevail in the regulatory framework that enable such episodes. This has been done by adopting a historical as well as an analytical approach. It is found that while the market regulator SEBI has undertaken countless measures to promote transparency, accountability, and security in the industry, there remain certain chinks in the armour which, if addressed, may reduce the occurrence of large-scale crises in the industry. In this*

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*regard, the paper aims to curate apposite suggestive changes in the regulatory structure, which may further help the regulator to assume a more preventive position against future hardships than a curative one.*

**Keywords:** mutual fund, debt MF crises, regulatory evolution, Franklin Templeton, regulatory loopholes

## I. INTRODUCTION

A mutual fund is a professionally managed investment fund consisting of money pooled from investors and put in several market instruments, like stock, bonds, money market instruments, etc. under different schemes. Section 2(q) of the SEBI (Mutual Funds) Regulations, 1996<sup>1</sup>, defines it as “*a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities including money market instruments or gold or gold-related instruments or real estate assets.*”

In India, this industry is controlled by the market regulator, the Securities and Exchange Board of India (“SEBI”), along with the Reserve Bank of India (“RBI”), which is responsible for regulating the money market and government securities that fund houses invest in; the Ministry of Finance, which supervises both SEBI and RBI; and the Company Law Board and the Registrar of Companies, which are responsible for supervising the Asset Management Companies (“AMCs”).

At present, the SEBI (Mutual Funds) Regulations 1996<sup>2</sup> govern the structure and operation of mutual funds in India. Apart from that, mutual funds are also governed by the relevant provisions of the Indian Trust Act 1882<sup>3</sup>, the Income Tax Act 2011<sup>4</sup>, and the Companies Act 2013<sup>5</sup>.

The structure of mutual funds has been decided by SEBI. It consists of a Sponsor, who establishes the mutual fund and

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<sup>1</sup> Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Gazette of India, pt. II, sec. 3 sub-sec. 3 (Dec. 9, 1996), sec. 2(q).

<sup>2</sup> Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Gazette of India, pt. II sec. 3 sub-sec. 3 (Dec. 9, 1996).

<sup>3</sup> The Indian Trusts Act, 1882, No. 2, Acts of Parliament, 1882.

<sup>4</sup> Income Tax Act, 1961, No. 43, Acts of Parliament, 1961.

<sup>5</sup> The Companies Act, 2013, No. 18, Acts of Parliament, 2013.

contributes at least 40% of the fund's net worth; a Board of Trustees, which is an independent body responsible for overseeing the working of the fund, ensuring compliance with the regulatory framework and working towards the investors' interests; an AMC, which invests the pooled money of the investors or unitholders into various market instruments; a Custodian, who is responsible for the safe-keeping of all the securities bought by the AMC and maintaining the investment account of the fund; and a Registrar and Transfer Agent, who is responsible for maintaining and updating the investors' records.

The Indian mutual fund industry has grown immensely since its inception in 1963 and thus, the need for regulations within it has also increased. The regulatory framework has significantly developed to meet the need of the changing times. Despite this, the industry has witnessed numerous financial crises in recent years, especially in the debt MF segment – with the latest being the sudden winding-up of six Franklin Templeton schemes in 2020 – which usher in massive losses for the investors and adversely affect the industry. This paper aims to study the regulatory evolution of the mutual fund industry over the years and the crises it had witnessed, analyse the reasons which still lead to such crises, and suggest changes in the regulatory framework to prevent similar incidents in the future.

## II. EVOLUTION OF THE REGULATORY FRAMEWORK OF THE INDIAN MUTUAL FUND INDUSTRY

### A. *1931-1987: Origin and the initial years of the mutual fund industry*

The Indian Central Banking Enquiry Committee Minority Report 1931<sup>6</sup> highlighted the need for the development of unit trusts to

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<sup>6</sup> Indian Central Banking Enquiry Committee, 1931, *Indian Central Banking Enquiry Committee, 1931. Vol. I, Part II: Minority Report* 325 (1931) (Last visited: Sep. 27, 2020).

initiate economic growth, but it was only after the stock market slipped into depression and it became difficult to raise capital from the market, that the Unit Trust of India (“UTI”) was finally established in 1964<sup>7</sup> under the Unit Trust of India Act, 1963 (“**UTI Act**”). Its successful operation encouraged the government to allow non-UTI public sector mutual funds post-1987. The consequent product innovation, excessive brand marketing, and innovation schemes captured a larger mutual fund market.<sup>8</sup> Finally, private fund houses, including foreign mutual funds, were also given the green light for entry.

To provide an effective regulatory framework for the new players, SEBI enacted the SEBI (Mutual Funds) Regulations, 1993 which were then replaced by the more comprehensive SEBI (Mutual Fund) Regulations, 1996<sup>9</sup>. These regulations were uniformly applicable to all mutual funds (excluding UTI) and removed unnecessary rigidities present in the previous framework, while also allowing greater transparency through provisions for proper disclosure, obligations of AMCs, etc. Thereafter, in 1995, the Association of Mutual Funds in India (“**AMFI**”) was established to further ensure the industry’s development in a professional and ethical manner.<sup>10</sup>

Ultimately, the UTI Act was repealed in 2002 after the failure of certain schemes leading to huge losses to the investors and by

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<sup>7</sup> Subhamoy Das, *Perspective on Financial Services* 6 (Sunil Sachdev at Allied Publishers Pvt. Ltd, 2009) (Last visited: Sep. 27, 2020).

<sup>8</sup> *Id.*

<sup>9</sup> Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Gazette of India, pt. II 3 sub-sec. 3 (Dec. 9, 1996).

<sup>10</sup> Association of Mutual Funds in India, *MF History*, AMFI INDIA, <https://www.amfiindia.com/research-information/mf-history> (last visited: June 10, 2020).

January 2003, all 33 mutual fund houses in the country were governed by SEBI regulations with AUM of Rs. 1,21,805 crores<sup>11</sup>.

### ***B. 2003-2014: Consolidation and Development***

Post the year 2000, as the private funds gained market dominance, SEBI introduced several regulations to ensure a smoother working of the industry. For instance, it mandated the Know Your Client (“KYC”)<sup>12</sup> process for all larger investments in 2008 to put a risk-management system in place for the prevention of fraudulent activities like money laundering. It also helped improve transparency with regards to the commission paid to the fund distributors and incentivise more long-term investment by the removal of entry load<sup>13</sup> on all mutual funds in August 2009<sup>14</sup>. SEBI reported that this step alone led to savings of Rs. 1300 crores for investors within the first 13 months of the ban.<sup>15</sup>

To combat the effects of the economic slowdown of 2008, SEBI also directed all mutual funds to launch schemes under a single plan and ensure that there is only a single expense structure<sup>16</sup>, to make the

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<sup>11</sup> *Id.*

<sup>12</sup> Securities and Exchange Board of India, *Master Circular on Anti Money Laundering and Combating Financing of Terrorism (AML and CFT) Standards-PDF*, SEBI.GOV.IN (December 19, 2008),

[https://www.sebi.gov.in/sebi\\_data/attachdocs/1332320892543.html](https://www.sebi.gov.in/sebi_data/attachdocs/1332320892543.html).

<sup>13</sup> Amount or fee charged from an investor by a mutual fund company while entering a scheme or joining the company as an investor. *Definition of Entry Load*, THE ECONOMIC TIMES, <https://economictimes.indiatimes.com/definition/entry-load#:~:text=Definition%3A%20Mutual%20fund%20companies%20collect,the%20company%20as%20an%20investor> (last visited: Feb. 21, 2021).

<sup>14</sup> Securities and Exchange Board of India, *Waiver of Load for Direct Applications*, SEBI.GOV.IN (Dec. 31, 2007), [https://www.sebi.gov.in/sebi\\_data/docfiles/9845\\_t.html](https://www.sebi.gov.in/sebi_data/docfiles/9845_t.html).

<sup>15</sup> Tanvi Verma/Monday Today, *Removal of Entry Load*, BUSINESS TODAY (Nov. 2010), <https://www.businesstoday.in/moneytoday/cover-story/removal-of-entry-load/story/9774.html#:~:text=Vaidyanathan%2C%20executive%20director%2C%20Sebi%2C,put%20to%20more%20productive%20use>.

<sup>16</sup> Securities and Exchange Board of India, *Steps to re-energise Mutual Fund Industry*, SEBI.GOV.IN (Sep. 13, 2012),

[https://www.sebi.gov.in/sebi\\_data/attachdocs/1347547815927.pdf](https://www.sebi.gov.in/sebi_data/attachdocs/1347547815927.pdf).



investment process easier and more systematic. Further, with the aim of restoring investor confidence, it also made it mandatory for all fund houses to set aside a part of their Total Expense Ratio for investor education and make a half-yearly disclosure of their financial results<sup>17</sup>. Such measures helped the industry grow in a recovering economy.

### *C. 2014-Present: Robust Growth Despite Frequent Debt Schemes Crises*

Since 2014, the MF industry has witnessed several crisis incidents. Despite this, a consistent rise in the overall AUM, as well as the number of investor accounts, has been observed.<sup>18</sup> SEBI has continued to introduce or revise regulations to ensure greater transparency, efficiency, and safety for all the stakeholders involved. For instance, the 2014 Budget changed the definition of 'long-term' for debt Mutual Funds ("**debt MFs**") from 12 months to 36 months, thus rendering any investment held for less than 36 months as a short-term one, and also increased the capital gains tax for such funds.<sup>19</sup> This was done to ensure that large investors could not take advantage of the lower tax rate by parking their funds in such schemes. Besides this, to increase investor confidence, the minimum capital requirement for all AMCs was increased to 50 crores to

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<sup>17</sup> Securities and Exchange Board of India, *SEBI Board Meeting*, SEBI.GOV.IN (Aug 16, 2012) [https://www.sebi.gov.in/media/press-releases/aug-2012/sebi-board-meeting\\_23255.html](https://www.sebi.gov.in/media/press-releases/aug-2012/sebi-board-meeting_23255.html).

<sup>18</sup> Association of Mutual Funds in India, *Indian Mutual Fund industry's Average Assets Under Management (AAUM) stood at ₹ 24.28 lakh crore (INR 24.28 Trillion)*, AMFI INDIA, <https://www.amfiindia.com/indian-mutual#:~:text=The%20Industry%27s%20AUM%20had%20crossed,first%20time%20in%20August%202017> (Sep. 28, 2020).

<sup>19</sup> ET Bureau, *FM Arun Jaitley offers only partial tax relief for investors in debt MFs*, THE ECONOMIC TIMES (Jul. 26, 2014, 08:18 AM), <https://economictimes.indiatimes.com/news/economy/policy/fm-arun-jaitley-offers-only-partial-tax-relief-for-investors-in-debt-mfs/articleshow/39004910.cms?from=mdr>.

ensure that fund houses were serious while setting up the business and investor confidence was maintained<sup>20</sup>, and it was also made mandatory for them to provide information about the commission paid to distributors in the new format of the Consolidated Account Statement in 2016.<sup>21</sup>

Other measures included the introduction of categorisation and rationalisation of similar mutual fund schemes in 2017 to showcase the uniformity in their characteristics and highlight the distinctions in terms of asset allocation, investment strategy, etc.<sup>22</sup> as well as asking mutual funds to benchmark their schemes against Total Return Index (TRI)<sup>23</sup> for a more accurate benchmark for performance comparison, with the aim of enabling the growing number of investors to easily compare the available schemes and increase awareness. Certain steps were also taken to directly curb disconcerting practices.<sup>24</sup> For instance, upfront commissions, *i.e.*, one-time commissions received by distributors on the sale of the AMC's scheme to an investor, were banned on almost all the schemes because to increase their income, some distributors would

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<sup>20</sup> BS Reporter, *AMCs to get 3 years to achieve Rs 50 cr net worth under new rule*, BUSINESS STANDARD (Feb. 19, 2014, 23:16 PM), [https://www.business-standard.com/article/markets/amcs-to-get-3-years-to-achieve-rs-50-cr-net-worth-under-new-rule-114021900742\\_1.html](https://www.business-standard.com/article/markets/amcs-to-get-3-years-to-achieve-rs-50-cr-net-worth-under-new-rule-114021900742_1.html).

<sup>21</sup> Securities and Exchange Board of India, *Circular on mutual funds*, SEBI.GOV.IN (Mar. 18, 2016), [https://www.sebi.gov.in/sebi\\_data/attachdocs/1458300086490.pdf](https://www.sebi.gov.in/sebi_data/attachdocs/1458300086490.pdf).

<sup>22</sup> Securities and Exchange Board of India, *Categorization and Rationalization of Mutual Fund Schemes*, SEBI.GOV.IN (Oct. 6, 2017), [https://www.sebi.gov.in/legal/circulars/oct-2017/categorization-and-rationalization-of-mutual-fund-schemes\\_36199.html](https://www.sebi.gov.in/legal/circulars/oct-2017/categorization-and-rationalization-of-mutual-fund-schemes_36199.html).

<sup>23</sup> Securities and Exchange Board of India, *Benchmarking of Scheme's Performance to Total Return Index*, SEBI.GOV.IN (Jan. 4, 2018), [https://www.sebi.gov.in/legal/circulars/jan-2018/benchmarking-of-scheme-s-performance-to-total-return-index\\_372](https://www.sebi.gov.in/legal/circulars/jan-2018/benchmarking-of-scheme-s-performance-to-total-return-index_372).

<sup>24</sup> Securities and Exchange Board of India, *Total Expense Ratio (TER) and Performance Disclosure for Mutual Funds*, SEBI.GOV.IN (Oct. 22, 2018), [https://www.sebi.gov.in/legal/circulars/oct-2018/total-expense-ratio-ter-and-performance-disclosure-for-mutual-funds\\_40766.html](https://www.sebi.gov.in/legal/circulars/oct-2018/total-expense-ratio-ter-and-performance-disclosure-for-mutual-funds_40766.html).

end up selling new funds showing unsatisfactory performance to the investors. This measure restrained such mis-selling of funds and portfolio churning.

Thus, scores of big and small changes have been introduced by SEBI for the evolution of the industry. In the past 5 years, the industry's AUM has undergone a two-fold increase and stood at Rs. 23.93 Lakh Crore as of 30<sup>th</sup> April 2020. The total number of folios, too, crossed the landmark of 9 crores.<sup>25</sup>

Despite the growth and the regulatory changes in the industry, there have still been instances of mismanagement, improper implementation of regulations, economic instability in the market, or simply the inherent risk in the business catching up with the fund houses, and causing problems for all the stakeholders – particularly in the debt segment of the mutual fund industry.

### III. AN ARRAY OF CRISES IN THE DEBT MF INDUSTRY

The debt MF industry saw a series of financial crises beginning in 2016, which resulted in considerable regulatory changes being introduced specifically to tackle these issues.

As an aftermath of the JP Mutual Fund crisis in 2015, in January 2016, SEBI reduced the limit of investment by a debt MF in securities sold by a single company and a group of issuer companies, while also decreasing the maximum investment in a single sector.<sup>26</sup> JP Mutual Fund had been forced to restrict redemptions for two of its debt schemes due to the fund house's collective exposure of Rs. 200

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<sup>25</sup> Association of Mutual Funds in India, *Indian Mutual Fund Industry's Average Assets Under Management (AAUM) stood at ₹ 24.28 lakh crore (INR 24.28 Trillion)*, AMFI INDIA, <https://www.amfiindia.com/indian-mutual#:~:text=The%20Industry%27s%20AUM%20had%20crossed,first%20time%20in%20August%202017> (Sep. 28, 2020).

<sup>26</sup> Securities and Exchange Board of India, *Circular on Mutual Funds*, SEBI.GOV.IN (Feb. 15, 2016), [https://www.sebi.gov.in/legal/circulars/feb-2016/circular-on-mutual-funds\\_31660.html](https://www.sebi.gov.in/legal/circulars/feb-2016/circular-on-mutual-funds_31660.html).

crores to the troubled firm Amtek Auto's debt papers, whose ratings were suspended unexpectedly. By restricting a fund's exposure to high levels of risks in a single company or sector, SEBI sought to address the risk concentration and credit issues. It also warned AMC's to avoid taking undue risks by investing in companies steeped in loans.<sup>27</sup> At the same time, it tightened regulations for credit rating agencies by asking them to disclose the procedure followed for ratings, the rating history, the responsibilities of analysts, etc<sup>28</sup> since this was just one of the examples of rating agencies causing sharp and sudden downgrades of corporate debt during the previous few months. According to SEBI data, credit rating agencies had downgraded mutual fund securities worth Rs. 13,000 crores by August 2015.<sup>29</sup> The unreliability of credit rating agencies continues to pose a hazard for the MF industry and requires further regulatory changes, some of which have been dealt with in a later section.

Moreover, in the above-mentioned case, JP Morgan MF had limited its redemptions to 1% of the units outstanding on any business day. However, it was later reported<sup>30</sup> that the AMC favoured some of its institutional investors and allowed them to

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<sup>27</sup> TNN, *Two JP Mutual Fund Schemes Restrict Redemptions*, TIMES OF INDIA (Aug. 31, 2015, 11:54 AM), <https://timesofindia.indiatimes.com/mf-news/Two-JP-Morgan-mutual-fund-schemes-restrict-redemption/articleshowsbcb/48740681.cms>.

<sup>28</sup> Jayshree P. Upadhyay, *CARE, Crisil Didn't Follow Due Process in AMTEC Auto Case: Sebi*, LIVEMINT (May 17, 2017, 03:37 AM), <https://www.livemint.com/Money/IIBGMtwx8169WK69PR0CAP/CARE-Crisil-didnt-follow-due-process-in-Amtek-Auto-case-S.html>.

<sup>29</sup> Anirudh Laskar, *SEBI urges mutual funds to stop relying solely on credit rating funds*, LIVEMINT (Oct. 1, 2015, 02:25 AM), <https://www.livemint.com/Money/JNLvb23lCT8Y6m6xmNSwZN/Sebi-urges-MFs-to-stop-relying-solely-on-credit-rating-firms.html>.

<sup>30</sup> Kayezad E. Adajania, *How bad is the JP Morgan Crisis?*, LIVEMINT (Sep. 9, 2015, 07:59 PM), <https://www.livemint.com/Money/bkMmKHML78f2L6zXevK9nI/How-bad-is-the-JP-Morgan-crisis.html>.

withdraw money just before imposing the redemption restrictions. To promote investors' safety in such crises, SEBI tightened the redemption rules, such as prohibiting the restriction of redemption requests up to Rs. 2 lakh and allowing it for greater amounts only after approval and for short periods in exceptional circumstances like market liquidity issues.<sup>31</sup>

Then, in 2018, India's leading infrastructure finance company, Infrastructure Leasing & Finance Services (IL&FS Ltd.), defaulted in payment obligations of bank loans, short-term deposits, and redemptions of commercial paper<sup>32</sup>. This led to a downgrade in the ratings of its short-term and long-term borrowings. Around 33 fund houses in the country had holdings of approximately Rs. 2,308 crores in IL&FS and the downgraded ratings forced many of them to mark down the value of their investment schemes in the company.<sup>33</sup> Overall, this incident also created volatility in debt and money market instruments issued by other non-banking financial institutions as the Net Asset Value ("NAV") of liquid mutual fund schemes declined. Reportedly<sup>34</sup>, the AUM of debt schemes fell by 18% in three months, ultimately resulting in widespread panic

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<sup>31</sup> Securities and Exchange Board of India, *Restriction on redemption in Mutual Funds*, SEBI.GOV.IN (May 31, 2016),

[https://www.sebi.gov.in/sebi\\_data/attachdocs/1464693701007.pdf](https://www.sebi.gov.in/sebi_data/attachdocs/1464693701007.pdf).

<sup>32</sup> ET Online, *IL&FS: The Crisis That Has India In Panic Mode*, THE ECONOMIC TIMES (Oct. 3, 2018, 11:37 AM)

<https://economictimes.indiatimes.com/industry/banking/finance/banking/everything-about-the-ilfs-crisis-that-has-india-in-panic-mode/articleshow/66026024.cms?from=mdr>.

<sup>33</sup> Kayezad E. Adajania, *IL&FS Crisis: How real is risk in debt funds?*, LIVEMINT (Oct. 1, 2018, 10:00 AM),

<https://www.livemint.com/Money/qsumSB9IZJrNUfKsOI0ngP/ILFS-crisis-How-real-is-the-risk-in-debt-funds.html>.

<sup>34</sup> Securities and Exchange Board of India, *Review of Risk Management Framework of Liquid Funds, Investment Norms and Valuation of Money Market and Debt Securities by Mutual Funds*, SEBI.GOV.IN, [https://www.sebi.gov.in/sebi\\_data/meetingfiles/sep-2019/1568030594032\\_1.pdf](https://www.sebi.gov.in/sebi_data/meetingfiles/sep-2019/1568030594032_1.pdf), (Sep. 28, 2020).

among the debt MF holders and greater redemption pressure on the fund companies.

The debt MF industry, in a state of financial crunch, was then further hit by the failure of the Essel group to repay its debt obligations. Mutual fund houses together had lent Rs. 7,000 crores against the debt securities of the Essel group. The debt was backed by shares of Zee Entertainment and Dish TV, owned by Essel, whose prices depleted in January, triggering defaults in payments of all instruments where they served as collateral.<sup>35</sup> The company then entered into standstill agreements with many of its mutual fund lenders, including Birla Sunlife, Franklin Templeton, HDFC, and ICICI Prudential, whereby they extended the repayment deadlines for its outstanding debt. As fund houses agreed to hold off selling the collateral shares, they were also forced to withhold a part of the redemptions for their fixed maturity plans that they had invested in Essel's debt instruments. However, SEBI stepped in to reiterate that AMC's could not enter into standstill agreements with borrowers as these adversely impacted investors by essentially disregarding Fixed Mutual Plan deadlines and increasing the risk exposure to payment defaults and eventual rating downgrades.<sup>36</sup>

Another distressing situation was created when the commercial papers of Dewan Housing Finance Corporation Ltd ("DHFL") were downgraded to 'D', *i.e.*, default, after the credit agencies felt that it would not be able to make repayments.<sup>37</sup> Several debt MF schemes

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<sup>35</sup> Menaka Joshi, *Are Mutual Funds About To Catch NPA Fever?*, BLOOMBERG QUINT (Apr. 12, 2019, 07:45 AM), <https://www.bloombergquint.com/opinion/are-mutual-funds-about-to-catch-npa-fever>.

<sup>36</sup> Anirudh Laskar, *MF's Borrowers Can't Have Standstill Pact, says SEBI*, LIVEMINT (Sep. 27, 2019, 11:49 AM), <https://www.livemint.com/mutual-fund/mf-news/sebi-chairman-asks-mutual-funds-to-refrain-from-standstill-agreements-1569487674975.html>.

<sup>37</sup> Joel Rabello, *Crisil, ICRA downgrade DHFL's CP rating to 'default grade'*, ECONOMICS TIMES (June 5, 2019, 07:52 PM),

had a collective exposure of Rs. 4323.14 crores to DHFL debt.<sup>38</sup> As redemptions failed again, panic among debt MF investors increased even more, as they lost faith in the previously held presumption of debt schemes being safe investments.

The YES Bank Crisis also added to investor troubles. YES Bank's assets fell short of its liabilities as, while the amount in the loan books grew, the deposits fell and withdrawals increased. Nearly 32 mutual fund schemes had made investments in YES Bank and the total exposure was around Rs. 2,848 crores.<sup>39</sup> Accordingly, the debt crisis in the bank resulted in the failure of redemptions, and many mutual funds were forced to write-off debt exposure to YES Bank.

In light of all these incidents, SEBI introduced new regulations<sup>40</sup> recommended by the Mutual Fund Advisory Committee constituted by it to enhance the risk management framework.<sup>41</sup> It limited the

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[https://economictimes.indiatimes.com/markets/stocks/news/crisil-downgrades-dhfls-cp-rating-to-d-as-firm-fails-to-pay-interest-on-bonds/articleshow/69663111.cms?from=mdr#:~:text=Mumbai%3A%20Rating%20agency%20Crisil%20has,debentures%20\(NCDs\)%20on%20Tuesday](https://economictimes.indiatimes.com/markets/stocks/news/crisil-downgrades-dhfls-cp-rating-to-d-as-firm-fails-to-pay-interest-on-bonds/articleshow/69663111.cms?from=mdr#:~:text=Mumbai%3A%20Rating%20agency%20Crisil%20has,debentures%20(NCDs)%20on%20Tuesday).

<sup>38</sup> Amit Shah, *These two fund houses alone had 56% exposure to industry's DHFL debt*, THE ECONOMIC TIMES (June 8, 2019, 04:53 PM),

<https://economictimes.indiatimes.com/markets/stocks/news/these-two-fund-houses-alone-have-56-exposure-to-dhfl-debt/articleshow/69700830.cms?from=mdr#:~:text=Of%20the%20mutual%20fund%20schemes%20total,are%20in%20debt%20schemes%20C%20Rs>.

<sup>39</sup> Nickey Mirchandani, *Here's How Much Mutual Funds Are Exposed to Yes Bank Debt*, BLOOMBERG QUINT (Mar. 6, 2020, 10:22 AM),

<https://www.bloomberquint.com/business/heres-how-much-mutual-funds-are-exposed-to-yes-bank-debt>.

<sup>40</sup> Securities and Exchange Board of India, *Review of investment norms for mutual funds for investment in debt and money market instruments*, SEBI.GOV.IN (Oct. 1, 2019), [https://www.sebi.gov.in/legal/circulars/oct-2019/review-of-investment-norms-for-mutual-funds-for-investment-in-debt-and-money-market-instruments\\_44556.html](https://www.sebi.gov.in/legal/circulars/oct-2019/review-of-investment-norms-for-mutual-funds-for-investment-in-debt-and-money-market-instruments_44556.html).

<sup>41</sup> Securities and Exchange Board of India, *Review of Risk Management Framework of Liquid Funds, Investment Norms and Valuation of Money Market and Debt Securities by Mutual Funds*, SEBI.GOV.IN, [https://www.sebi.gov.in/sebi\\_data/meetingfiles/sep-2019/1568030594032\\_1.pdf](https://www.sebi.gov.in/sebi_data/meetingfiles/sep-2019/1568030594032_1.pdf) (Sep. 28, 2020).

exposure of a debt MF in a single sector, as well as its investment in Non-Convertible Debentures. It also restricted liquid funds from parking their investments in short-term deposits of banks and fixed deposits, and in unlisted debt instruments. However, the restriction imposed on unlisted instruments created a different issue, which has been dealt with in detail in a later section.

Further, to increase liquidity and address concerns regarding the safety of AUM of debt funds, it mandated liquid funds to keep aside at least a fifth of their assets in cash and cash equivalents to meet sudden redemption demands<sup>42</sup>, while also restricting exposure to unrated debt, *i.e.*, ungraded debts of small companies that are unable to pay rating agencies due to financial constraints. Additionally, to make AMC's more proactive and objective in assessing the creditworthiness of issuers and reducing their dependence on sudden and volatile ratings by Credit Rating Agencies ("CRAs"), it instructed mutual funds to have a credit risk assessment policy and early warning system in place for quick recognition of deterioration in the credit risk profile of the issuer.

A compulsion was also placed on the listed companies to make disclosures with regards to all loan defaults.<sup>43</sup> SEBI also allowed the trustees of the AMC to choose the option of side-pocketing in mutual fund schemes.<sup>44</sup> Creating a side pocket allows the fund houses to separate the illiquid debt instruments present in the scheme, which

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<sup>42</sup> *Id.*

<sup>43</sup> Securities and Exchange Board of India, *Disclosures by listed entities of defaults on payment of interest/ repayment of principal amount on loans from banks / financial institutions and unlisted debt securities*, SEBI.GOV.IN (Nov. 21, 2019) [https://www.sebi.gov.in/legal/circulars/nov-2019/disclosures-by-listed-entities-of-defaults-on-payment-of-interest-repayment-of-principal-amount-on-loans-from-banks-financial-institutions-and-unlisted-debt-securities\\_45036.html](https://www.sebi.gov.in/legal/circulars/nov-2019/disclosures-by-listed-entities-of-defaults-on-payment-of-interest-repayment-of-principal-amount-on-loans-from-banks-financial-institutions-and-unlisted-debt-securities_45036.html) (last visited: Sep. 28, 2020).

<sup>44</sup> Securities and Exchange Board of India, *Side Pocketing by Mutual Funds*, SEBI.GOV.IN, [https://www.sebi.gov.in/sebi\\_data/meetingfiles/jan-2019/1547536633423\\_1.pdf](https://www.sebi.gov.in/sebi_data/meetingfiles/jan-2019/1547536633423_1.pdf) (Sep. 28, 2020).



have been given the credit rating 'D', on the day they are downgraded. Essentially, it creates two schemes from the one scheme in which investments had been made. These two schemes have different NAVs and redemptions and new investments are allowed to be made only from the liquid scheme, while the redemptions from the illiquid schemes are made as and when the debt instrument is matured or can be sold. This helps in ensuring that the loss is spread over all unitholders. However, both the disclosure system and the process of side-pocketing require further regulatory supervision to effectively cover the loopholes that may lead to future crises.

While the debt MF industry was still in shackles, the economic slowdown due to the coronavirus pandemic only made things worse. To tackle the same, in April 2020, SEBI announced relaxations on the valuation of money and debt market instruments held by mutual funds in view of the liquidity issues arising from the coronavirus pandemic and RBI's order of the three-month moratorium by financial entities to borrowers to provide relief against the same<sup>45</sup>. The regulator said that if the valuation agencies appointed by AMFI found that a delay in payment of interest or principal of a security had risen solely due to the coronavirus pandemic lockdown or in light of RBI moratorium, they may not consider it as default for valuing money and debt market securities held by mutual funds.<sup>46</sup>

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<sup>45</sup> ETMarkets.com, *Covid-19 Crisis: Sebi Relaxes Valuation Criteria for MF Debt Securities*, THE ECONOMIC TIMES (Apr. 23, 2020, 6:06 PM), <https://economictimes.indiatimes.com/markets/stocks/news/covid-19-crisis-sebi-relaxes-valuation-criteria-for-mfs-debt-securities/articleshow/75324006.cms?from=mdr>.

<sup>46</sup> Securities and Exchange Board of India, *Review of provisions of the circular dated September 24, 2019 issued under SEBI (Mutual Funds) Regulations, 1996 due to the COVID - 19 pandemic and moratorium permitted by RBI*, SEBI.GOV.IN (Apr. 23, 2020), <https://www.sebi.gov.in/legal/circulars/apr-2020/review-of-provisions-of-the-circular-dated-september-24-2019-issued-under-sebi-mutual-funds-regulations->

#### IV. THE FRANKLIN TEMPLETON MELTDOWN IN 2020

The most recent case of financial distress in the debt MF industry took place on 24<sup>th</sup> April 2020, when Franklin Templeton Asset Management (India) Pvt. Ltd., the ninth-largest mutual fund house in the country, announced the winding-up of six of its debt MF schemes.<sup>47</sup> These were the Franklin India Ultra Short Bond Fund, Franklin India Short Term Income Fund, Franklin India Credit Risk Fund, Franklin India Low Duration Fund, Franklin India Dynamic Accrual Fund, and the Franklin India Income Opportunities Fund. Four of these schemes had performed the worst in 2019 compared to the previous 7 to 10 years of annual performance. Many of them again took a hit in January 2020, with their NAVs falling in the range of 5-7% on a single day.<sup>48</sup>

This backdrop of poor performance proved more lethal when combined with the increased redemption pressure and market volatility brought by the COVID-19 pandemic, and the company decided to shut down the schemes under Section 39 of the SEBI (Mutual Fund) Regulations, 1996.<sup>49</sup> Such a voluntary, large-scale shutdown was unprecedented for Indian markets and sent shockwaves through the industry.

##### *A. Reasons for the Crisis*

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1996-due-to-the-covid-19-pandemic-and-moratorium-permitted-by-rbi\_46549.html.

<sup>47</sup> Franklin Templeton Mutual Fund, *Notice of winding-up specific schemes*, FRANKLINTempletonIndia.COM (Apr. 23, 2020), <https://www.franklintempletonindia.com/downloadsServlet/pdf/notice-of-winding-up-specific-schemes-k8lf815l>.

<sup>48</sup> Avneet Kaur, *Should you worry about your investments in Franklin Templeton debt MF schemes?*, THE ECONOMIC TIMES (Jan. 17, 2020, 03:29 PM), <https://economictimes.indiatimes.com/mf/analysis/should-you-worry-about-your-investments-in-franklin-templeton-debt-mutual-fund-schemes/articleshow/73326189.cms?from=mdr>.

<sup>49</sup> Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Gazette of India, Pt. II, Sec. 3 Sub. Sec. 3, (Dec. 9, 1996), Sec. 39.

The poor performance and subsequent winding-up of the schemes were a result of various reasons. Firstly, there had been a trend of illiquidity in the market, which began with the IL&FS case and continued further. This caused numerous companies (including those in Franklin Templeton's portfolio) to default on payments, resulting in repercussions for the mutual fund houses that had lent to them.

Secondly and most importantly, all six of the company's schemes had bought debt instruments ranked below AAA (the safest rating for private debt). They were managed by Santosh Kamath, the Chief Investment Officer for fixed income, known for managing credit risk schemes and buying such risky investments.<sup>50</sup> This strategy allows better returns for the investors as the higher risk involved in investing in such low-rated and unpredictable securities translates to higher interest rates. This strategy did yield good results in the past, and in fact, created a market for such risky securities in the industry.

However, five of the now-wound-up schemes were not credit risk funds, yet they ended up focusing considerably on investing in high credit risk securities despite the company already having a separate credit risk fund for that. For instance, the Franklin Low Duration Fund, which was a debt scheme with a duration of 6-12 months, had invested nearly 44% of its value in risky assets with a low grade. Similarly, the Franklin India Ultra Short Bond Fund, meant for 3-6 months duration, had invested nearly 28% in securities with a credit rating of 'A' and below. Compared to this, the industry

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<sup>50</sup> Jayshree P. Upadhyay, Neil Borate, *The Star Fund Manager with a Cult Following, Who Finally Lost His Mojo*, LIVEMINT (Apr. 28, 2020, 12:45 AM), <https://www.livemint.com/companies/news/franklin-templeton-when-the-cult-of-star-fund-managers-fails-11587911655595.html>.

average of such investments per scheme was 10% and 3% respectively.<sup>51</sup>

Moreover, some of the fund houses' investments were particularly risky. According to reports<sup>52</sup>, Franklin Templeton was the only lender to 26 entities (out of 88) in its debt schemes' portfolio, which meant that if these borrowers faced financial trouble, the mutual fund house would have to bear the brunt alone.

Unsurprisingly, the company had a history of facing troubled borrowers. It held nearly all the zero-coupon bonds of Yes Capital, run by the co-founder of Yes Bank - an entity that went on to fall apart later.<sup>53</sup> Similarly, the company had also made investments in Essel Group, DHFL, and Reliance Anil Dhirubhai Ambani Group which also faced financial crises in the previous year and were unable to make repayments.<sup>54</sup>

Even in schemes that were supposed to be safe, Franklin had a tendency to take extra risks (for example structured, complex deals, and poor-quality paper) to increase its returns. It had also reportedly violated rules regarding portfolio diversification and accurate classification of funds.<sup>55</sup> To check these and other allegations

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<sup>51</sup> Kayezad E Adajania, *The inside story of what led to the mess at Franklin Templeton*, MONEYCONTROL (Apr. 27, 2020, 02:57 PM),

<https://www.moneycontrol.com/news/business/personal-finance/the-inside-story-of-what-led-to-the-mess-at-franklin-templeton-5192431.html>.

<sup>52</sup> Sandeep Singh, George Mathew, *Franklin Templeton put money in less known, low-rated firms*, INDIAN EXPRESS (Apr. 26, 2020, 08:55 AM),

<https://indianexpress.com/article/business/banking-and-finance/franklin-put-money-in-unknown-unrated-firms-6379465/>.

<sup>53</sup> Andy Mukherjee, *Templeton fund freeze leaves a dangerous hole*, BLOOMBERG QUINT (Apr. 28, 2020, 07:21 AM), <https://www.bloombergquint.com/opinion/templeton-fund-freeze-leaves-india-in-a-dangerous-debt-hole>.

<sup>54</sup> *Supra*, note 78.

<sup>55</sup> ET Contributors, *View: We need institutional and legislative reforms to avoid a repeat of panic in debt MFs*, THE ECONOMIC TIMES (May 1, 2020, 09:48 AM), <https://economictimes.indiatimes.com/mf/analysis/view-we-need-legislative-and-institutional-reforms-to-avoid-a-repeat-of-panic-in-debt-mutual->

regarding fraud and malpractice, SEBI ordered an investigation into the company after the meltdown.<sup>56</sup>

The concern amongst investors regarding the high levels of risk was enunciated to the point of action by the widespread economic distress brought by the pandemic, and many of them began pulling out their investments. The sudden huge redemption pressure forced the company to sell its debt investments. However, the high-risk profile of the instruments made it difficult to find buyers. The other option left with the company was to borrow funds to pay back investors, but eventually, it seems that even the borrowing limit was reached.<sup>57</sup> Ultimately, the only choice Templeton was left with was to wind up its schemes.

### *B. Immediate Impact*

The schemes together held nearly Rs. 26,000 crores of investor assets, amounting to around a quarter of the company's AUM.<sup>58</sup> The winding-up meant that investors could no longer withdraw their money based on the value of underlying assets, which thus became frozen. This converted the open-ended schemes promising easy withdrawal into close-ended ones overnight.

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funds/articleshow/75458400.cms?utm\_source=contentofinterest&utm\_medium=text&utm\_campaign=cppst.

<sup>56</sup> Jayshree P. Upadhyay, Anirudh Laskar, *Market regulator SEBI probes Franklin Templeton India unit*, LIVEMINT (May 4, 2020, 12:37 AM), <https://www.livemint.com/news/india/franklin-templeton-s-decision-to-wind-up-6-debt-schemes-attracts-multiple-probes-11588503867942.html>.

<sup>57</sup> Sunil Dhawan, *Franklin Templeton: Not just credit risk, other debt funds also under lockdown; Is your investment safe?*, FINANCIAL EXPRESS (Apr. 24, 2020, 08:31 AM), <https://www.financialexpress.com/money/mutual-funds/franklin-templeton-india-fund-closure-is-your-debt-fund-investment-safe/1938529/>.

<sup>58</sup> Furquan Moharkan, *Franklin Templeton locks up Rs. 26,000 crore across 6 schemes*, DECCAN HERALD (Apr. 24, 2020, 23:45 PM), <https://www.deccanherald.com/business/economy-business/franklin-templeton-locks-up-rs-26000-crore-across-6-schemes-829508.html>.

Some of the company's fund-of-funds, *i.e.*, funds that invest only in other mutual funds, also took a hit as Franklin Templeton marked down their investments. This happened as these funds had investments in the 6 now-wound-up schemes.<sup>59</sup> Thus, the company restricted inflows into three of these fund-of-funds to protect existing investors, by preventing new ones from benefiting from any recovery in the wound-up scheme's holdings.<sup>60</sup>

The President of the India unit, Sanjay Sapre, assured investors<sup>61</sup> that the schemes will try to return the investment money at the earliest possible time by monetizing the underlying assets in the portfolio without resorting to any distress sales. Consequently, the company reached out to investors to verify their details like PAN and folio numbers, email addresses, etc. and appointed Kotak Mahindra Bank to work with it on portfolio actions.

Some other Templeton investors who also got caught in this turmoil were those who had enrolled for Systematic Transfer Plans ("STPs"). STPs allow investors to park their money in a debt fund temporarily and carry out a monthly or weekly transfer to an equity scheme within the same house. This crisis meant that those who had

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<sup>59</sup> Suresh P. Iyengar, *Franklin taps fixed income plans to meet redemption pressure*, THE HINDU BUSINESS LINE (Apr. 27, 2020),

<https://www.thehindubusinessline.com/markets/stock-markets/franklin-templeton-mops-up-liquidity-to-meet-redemption-in-other-debt-schemes/article31443909.ece>.

<sup>60</sup> Prashant Mahesh, *Franklin Templeton imposes investment curbs on 3 FoF schemes*, THE ECONOMIC TIMES (Aug. 18, 2020),

<https://economictimes.indiatimes.com/markets/stocks/news/franklin-templeton-imposes-investment-curbs-on-3-fof-schemes/articleshow/77619398.cms>.

<sup>61</sup> Sanjay Sapre, *Letter from our President to Investors*, FRANKLINTempletonINDIA.COM,

<http://image.e.franklintempleton.com/lib/fe4715707564047e751474/m/3/48245cfe-2682-4b98-8c23-4ae1baaa157c.pdf> (Sep. 28, 2020).

parked their money in the six schemes, waiting to move to equity funds, were also stuck with their money not invested in equity yet.<sup>62</sup>

Another group likely to suffer will be the troubled companies having lower ratings. They have generally found it difficult to access financial aid, with only certain funds like the high credit-risk ones of Franklin Templeton lending to them, but an incident like this would possibly restrain fund houses from dabbling in their sector anytime soon.

### *C. Aftermath and Implications for The Mutual Fund Industry*

Almost a month later, SEBI allowed Franklin Templeton to list units of its wound-up schemes on stock exchanges as an alternative exit option to the investors.<sup>63</sup> In fact, this new provision has been made available to all mutual funds winding up their schemes in the future, in the spirit of ensuring liquidity.

Besides that, the company began looking for opportunities to monetize its existing assets. The maturities of securities, coupon payments, and pre-payments by issuers led to five of the six schemes turning cash positive and receiving a total cash flow of Rs. 14,391 crores by the end of January 2021.<sup>64</sup>

However, the company faced multiple setbacks in the distribution process. In late May, the e-voting notices issued by the AMC to unitholders to obtain their authorization for monetizing the

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<sup>62</sup> Special Correspondent, *Fault lines exposed in MF industry: Tyagi*, THE HINDU (Aug. 27, 2019, 23:09 PM), <https://www.thehindu.com/business/fault-lines-exposed-in-mf-industry-tyagi/article29271930.ece>.

<sup>63</sup> Jayshree P. Upadhyay, *SEBI allows Franklin Templeton's shut schemes to list on bourses*, LIVEMINT (May 21, 2020, 12:13 AM), <https://www.livemint.com/companies/news/sebi-provides-franklin-templeton-investors-an-exit-option-via-stock-exchange-11589981380961.html>.

<sup>64</sup> *Franklin Templeton MF's six schemes generate Rs 14,391 cr*, THE ECONOMIC TIMES (Feb. 1, 2021, 2:21 PM), <https://economictimes.indiatimes.com/mf/mf-news/franklin-templeton-mfs-six-shut-schemes-generate-rs-14391-cr/articleshow/80628138.cms?from=mdr>.

underlying securities was stayed by the Gujarat High Court on the grounds that the winding-up was initiated without the investors' consent, though the company argued that the notices had been issued in consultation with SEBI. Subsequently, the Apex Court directed the entire batch of investor petitions in the matter from the Delhi, Madras, and Gujarat High Courts to the Karnataka High Court.<sup>65</sup> In October, the latter held that the unitholders' consent should have been obtained before initiating the winding-up process and stayed the winding-up until such a vote was taken. This was challenged by the AMC in the Supreme Court, under whose directions the e-voting process was conducted in December and its sealed results produced before the Court. Finally, the Supreme Court in February 2021 upheld the validity of the e-voting process for the winding-up of the six schemes by Franklin Templeton, wherein 96% of the unitholders voted in favour of an orderly winding-up. It also ordered the disbursal of the Rs. 9122 crores collected until 15<sup>th</sup> January in proportion to the unitholders' interest in the assets.<sup>66</sup>

However, Franklin's troubles are far from over. An FIR was lodged against the company and its top officials by the Economic Offences Wing of the Chennai Police for alleged criminal conspiracy to defraud over 3 lakh investors, causing wrongful loss to them and unlawful gain to themselves. Such a complaint against a fund house is unprecedented in the industry.<sup>67</sup> The Madras High Court in

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<sup>65</sup> Prashant Mahesh, *Franklin Templeton imposes investment curbs on 3 FoF schemes*, THE ECONOMIC TIMES (Aug. 18, 2020),

<https://economictimes.indiatimes.com/markets/stocks/news/franklin-templeton-imposes-investment-curbs-on-3-fof-schemes/articleshow/77619398.cms>.

<sup>66</sup> *Franklin Templeton: SC upholds the validity of e-voting for winding up six MFs*, BUSINESS STANDARD (Feb. 12, 2021, 12:22 PM), [https://www.business-standard.com/article/pti-stories/sc-upholds-validity-of-e-voting-for-winding-up-of-six-mutual-fund-schemes-of-franklin-templeton-121021200594\\_1.html](https://www.business-standard.com/article/pti-stories/sc-upholds-validity-of-e-voting-for-winding-up-of-six-mutual-fund-schemes-of-franklin-templeton-121021200594_1.html).

<sup>67</sup> Suresh P. Iyengar, *AMFI asks SEBI to Stop Police Probe Against Franklin Templeton, Officials*, HINDU BUSINESS LINE (Sept. 30, 2020),

<https://www.thehindubusinessline.com/markets/stock-markets/amfi-asks-sebi-to-stop-police-probe-against-franklin-templeton-officials/article32734425.ece>.



January ordered the Economic Offences Wing to file a detailed report seeking criminal action. Moreover, the audit report that comes as a result of the SEBI-ordered investigation into the AMC has highlighted the 'unusual withdrawals' from the wound-up schemes being over three times the usual levels reported by the fund, just a few weeks before the announcement of their suspension. A show-cause notice has been issued to the company.<sup>68</sup>

In order to reassure investors and enable mutual funds to meet higher redemption pressures, RBI stepped in and released a liquidity fund of Rs. 50,000 crores to be used by banks exclusively for lending to meet the liquidity requirements of the mutual funds.<sup>69</sup> Moreover, post the Franklin Templeton crisis, SEBI once again spurred into action and introduced regulations to closely monitor other debt fund schemes, with the purpose of preventing other funds from going the same way, especially in the current strained economy. It has sought extensive details from mutual funds regarding their debt schemes portfolio, their liquidity profiles, and the ability to meet large redemptions. It also relaxed the restriction on transactions in grandfathered unlisted debentures and extended the timeline to reduce the exposure to unlisted Non- Convertible Debentures over the course of last year.<sup>70</sup> Additionally, it introduced the very-high-risk category in its Risk-o-meter in order to warn investors against

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<sup>68</sup> *SEBI asks Franklin Templeton to explain 'unusual' redemptions of \$2b*, THE HINDU BUSINESS LINE (Jan. 25, 2021),

<https://www.thehindubusinessline.com/markets/stock-markets/sebi-asks-franklin-templeton-to-explain-unusual-redemptions-of-2-b/article33661426.ece>.

<sup>69</sup> Reserve Bank of India, *RBI Announces ₹ 50,000 crore Special Liquidity Facility for Mutual Funds (SLF-MF)*, RBI.ORG.IN (Apr. 27, 2020),

[https://www.rbi.org.in/Scripts/BS\\_PressReleaseDisplay.aspx?prid=49728](https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=49728).

<sup>70</sup> Rajesh Gajra, *SEBI Watch: Hasten security of debt funds to dispel investor concerns*, COGENCIS (Apr. 30, 2020),

<http://www.cogencis.com/newssection/sebi-watchhasten-scrutiny-of-debt-funds-to-dispel-investor-concerns/>.

dangerous investments.<sup>71</sup> Such measures can prevent further diminishing of investor confidence and help the industry recover from the Franklin Templeton incident. Further, given the impact COVID-19 has had on the economy, these steps allow companies more time and opportunity to become more investor-friendly and prepared to meet redemption requests.

## V. LOOPHOLES IN THE REGULATORY FRAMEWORK

With the growth in the mutual fund industry, SEBI has actively performed its functions as the market regulator and introduced regulations to meet the needs of the changing face of the industry. However, the regulatory framework of the mutual fund industry still has loopholes, especially pertaining to the debt segment, which have been observed after studying the market crises.

One of the loopholes is the use of floating rate bonds that do not have a fixed interest rate, with the rate being reset at pre-decided intervals. The issue is that mutual funds, like Franklin Templeton, use these bonds to repackage a long-term bond as a short-term or even ultra-short-term one, based on the short duration like 6 months in which the interest rate payable is reset. SEBI provides fund houses with the advantage of using average duration for categorisation. Through this, they average out the duration of a couple of long-term papers with mostly short-term ones to ultimately meet the categorization criteria of short-term, thereby selling them together as a short-term fund and misleading investors as to when they would receive their money. This becomes a bigger problem when, like in the Franklin incident, a scheme is shut down – investors then have

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<sup>71</sup> SEBI introduces very high risk category in mutual fund schemes, THE ECONOMIC TIMES (Oct. 6, 2020, 11:43 AM), <https://economictimes.indiatimes.com/mf/mf-news/sebi-introduces-very-high-risk-category-in-mutual-fund-schemes/articleshow/78508751.cms>.

to wait for the maturity of the floating rate bond over a longer duration, even though the scheme is a short-term one.<sup>72</sup>

Another loophole that puts the investors' money at risk is the existence of perpetual bonds in short-term schemes, like Additional Tier 1 Bonds. Such bonds have no expiration date and do not have a put option to allow a bondholder to ask for repayment of the principal amount. However, these bonds are callable, *i.e.*, the issuer can call back the bond before it matures by simply paying back the principal and interest amount. Such bonds are being issued in fixed duration and even short-term debt MFs, despite their perpetual period, restricting the investors' freedom to withdraw their money in the short run.

Another problem for investors is the retention of unlisted bonds that cannot be traded. SEBI has introduced a regulation that prevents the fund houses from trading unlisted bonds<sup>73</sup>, which forces the fund houses which had already invested in them to retain these bonds till they mature. Amidst redemption pressure, the inability to sell these bonds and realise their value creates a big hurdle for mutual fund houses. Moreover, since they continue to be in the scheme, these bonds are still reflected in the NAV of the scheme and thus lead to misinformation for the investors.

Side-pocketing, which has been discussed earlier as a measure to separate illiquid debt instruments, may also act as a double-edged sword. On one hand, this practice safeguards the interest of investors at large by spreading the loss amongst them, rather than letting some

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<sup>72</sup> Vashistha Iyer, *Podcast #27: The run on debts mutual funds. Is your money safe?*, CAPITAL MIND (May 4, 2020), <https://www.capitalmind.in/2020/05/podcast-27-the-run-on-debt-mutual-funds-is-your-money-safe/>.

<sup>73</sup> Securities and Exchange Board of India, *Review of investment norms for mutual funds for investment in debt and money market instruments*, SEBI.GOV.IN (Oct. 1, 2019), [https://www.sebi.gov.in/legal/circulars/oct-2019/review-of-investment-norms-for-mutual-funds-for-investment-in-debt-and-money-market-instruments\\_44556.html](https://www.sebi.gov.in/legal/circulars/oct-2019/review-of-investment-norms-for-mutual-funds-for-investment-in-debt-and-money-market-instruments_44556.html).

investors take the first-movers advantage, which is why it was introduced by SEBI post the debt repayment defaults.<sup>74</sup> By creating the side pocket of illiquid funds, the NAV of the scheme reflects the actual realisable value. However, on the other hand, this provision also allows fund managers to hide poor investment decisions. Although SEBI has placed some safeguards on this by providing that the decision of side-pocketing be approved by the trustees who must ensure that this step would not negatively affect the performance incentives of fund managers, chief investment officers, etc., the framework of mutual funds is such that the interrelation between the sponsor, trustee and the AMC cannot be denied and their clear independence established. Thus, the lack of any supervision by the market regulator with regards to side-pocketing and wide powers with trustees alone creates uncertainty in ensuring investor protection and opens a window for fund managers to make riskier investment choices.

One major loophole that leads to investor confusion is the considerable number of categories. Moreover, in debt funds, there is a lack of common criteria for classification, with one category being based on the time of the return of investment while another is defined by the rating or credit profile of the securities. There also sometimes arises mislabelling of funds, like calling debt schemes fixed income schemes, which gives investors the impression that they are similar to bank fixed deposits. This was also allegedly seen in the case of Franklin Templeton, as the company labelled its credit risk schemes as yield-oriented credit schemes, while industry body AMFI classified them as income schemes, a separate category altogether. Such mislabelling results in a misrepresentation of the risk involved to the investors.<sup>75</sup>

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<sup>74</sup> *Id.*

<sup>75</sup> Jayshree P. Upadhyay, Anirudh Laskar, *Market regulator SEBI probes Franklin Templeton India unit*, LIVEMINT (May 4, 2020, 12:37 AM),

Another point of confusion for the investors arises on account of disclosure complexity. SEBI has always adopted a disclosure-based approach, forming regulations for various players in the market to make adequate disclosures regarding the rating procedure, schemes diversification, the associated risks, commissions and incentives paid, etc. However, these disclosures are often dense, full of jargon, and voluminous, which makes comprehension difficult for the average investor. Thus, they result in misleading the investors or worse, hiding crucial information within an abundance of unintelligible legalese. One example is the commission disclosure requirement in the CAS introduced in 2016.<sup>76</sup> The unclear method of disclosure leads to several obscurities – the commission paid being clubbed with the Total Expense Ratio makes the actual amount paid to distributors seem inflated; there is no mention of the earning period, which investors then assume to be monthly, but is actually half-yearly; and the commission is expressed in absolute amounts instead of a percentage of the assets, which hinders investors from understanding the information in proper perspective.<sup>77</sup>

In the Amtek Auto case, the primary reason which led to the crisis was the unreliability of the CRAs. Due to mismanagement and improper monitoring by CRAs, the company's securities' ratings were suspended overnight from the highest ratings on the grounds of financial troubles without following due procedure.<sup>78</sup> Similarly,

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<https://www.livemint.com/news/india/franklin-templeton-s-decision-to-wind-up-6-debt-schemes-attracts-multiple-probes-11588503867942.html>.

<sup>76</sup> Securities and Exchange Board of India, *Circular on mutual funds*, SEBI.GOV.IN (Mar. 18, 2016), [https://www.sebi.gov.in/sebi\\_data/attachdocs/1458300086490.pdf](https://www.sebi.gov.in/sebi_data/attachdocs/1458300086490.pdf).

<sup>77</sup> Aniruddha Bose, *Decoding the Commission Disclosures on your ECAS*, BUSINESS WORLD (June 21, 2017), <http://www.businessworld.in/article/Decoding-The-Commission-Disclosure-On-Your-eCAS/21-06-2017-120521/>.

<sup>78</sup> Jayshree P. Upadhyay, *CARE, Crisil Didn't Follow Due Process in AMTEC Auto Case: Sebi*, LIVEMINT (May 17, 2017, 03:37 AM),

<https://www.livemint.com/Money/IIBGMtwx8169WK69PR0CAP/CARE-Crisil-didnt-follow-due-process-in-Amtek-Auto-case-S.html>.

rating agencies failed to detect trouble in IL&FS, DHFL, Zee and Reliance Communications, etc. as they grew over time. A study<sup>79</sup> has indicated that for the ten corporate groups responsible for 20% of all distressed loans from 2011 to 2016, the total debt had jumped from Rs. 3 lakh crore to Rs. 7 lakh crore by 2014 and yet, they were all rated in the 'No Risk' or 'Low Risk' category until they finally started defaulting on payments.

While there exists a comprehensive legislative framework for CRAs in the form of SEBI (Credit Rating Agencies) Regulations, 1999<sup>80</sup>, which have been amended from time to time, there remain concerns regarding the reliability and accuracy of CRAs. For one, CRA Regulations only recognise the 'issuer pays' model, *i.e.*, issuer entities hire CRAs to rate their securities and remunerate them for it. This can create a conflict of interest. It also makes rating agencies dependent on the issuers for information regarding their finances. Secondly, while SEBI provides for actions against CRAs for unfair practices or defaults, they have rarely undertaken them. Thirdly, CRAs' responsibility towards investors is undermined since there is no mechanism for them to enforce this responsibility and claim compensation for losses resulting from their negligent or fraudulent rating.<sup>81</sup> Moreover, issuers also sometimes partake in 'rating

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<sup>79</sup> Praveen Chakravarty, *The Silent Role of Credit Ratings in India's Bad Loan Crisis*, BLOOMBERG QUINT (July 8, 2016, 06:06 AM),

[https://www.bloombergquint.com/opinion/the-silent-role-of-credit-ratings-in-indias-badloan-](https://www.bloombergquint.com/opinion/the-silent-role-of-credit-ratings-in-indias-badloan-crisis#:~:text=The%20numbers%20are%20stark.&text=Credit%20Suisse%20famously%20called%20these,frontal%20attacks%20instigating%20this%20crisis.)

[crisis#:~:text=The%20numbers%20are%20stark.&text=Credit%20Suisse%20famously%20called%20these,frontal%20attacks%20instigating%20this%20crisis.](https://www.bloombergquint.com/opinion/the-silent-role-of-credit-ratings-in-indias-badloan-crisis#:~:text=The%20numbers%20are%20stark.&text=Credit%20Suisse%20famously%20called%20these,frontal%20attacks%20instigating%20this%20crisis.)

<sup>80</sup> Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, Gazette of India, Pt. II, Sec. 3 Sub. Sec. 2 (July 7, 1999).

<sup>81</sup> Shreya Prakash et. al., *Regulation of Credit Rating Agencies in India* 23 VIDHI CENTRE FOR LEGAL POLICY (July, 2017), [https://vidhilegalpolicy.in/wp-content/uploads/2019/05/170731\\_CRAREport.pdf](https://vidhilegalpolicy.in/wp-content/uploads/2019/05/170731_CRAREport.pdf).

shopping' - pressurizing CRAs to deliver favourable ratings against the threat of denying future business.<sup>82</sup>

Lastly, the current system of incentives present in the industry results in making it less investor-friendly, as the fund industry's income and incentives are generally based on the amount of money collected from investors. This leads to a more asset-gathering-based objective where fund managers are occupied with luring more investors and increasing the AUM, rather than acting as a trustee and manager of other people's money and raising higher returns for them. There have been reports of fund managers supposedly entering into deals with corporates to rake in more cash, without considering the best interests of the investors.<sup>83</sup> Such deals may lead to investments in poor-performing sectors and entities, causing the ultimate breakdown of those MF schemes.

Clearly, the regulatory framework of the industry contains several loopholes. With the objective of earning high returns, the fund managers take advantage of these loopholes but put the investors at greater risk, and hence they must be addressed using appropriate solutions.

## VI. SUGGESTIONS

The following are some suggestions for reforms to address the current loopholes in the mutual fund regulatory mechanism in the country.

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<sup>82</sup> Anup Roy, *RBI Raises Concerns About Companies Shopping Around for Favourable Ratings*, BUSINESS STANDARD (Dec. 28, 2019, 11:56 PM), [https://www.business-standard.com/article/economy-policy/rbi-raises-concerns-about-companies-shopping-around-for-favourable-ratings-119122800870\\_1.html](https://www.business-standard.com/article/economy-policy/rbi-raises-concerns-about-companies-shopping-around-for-favourable-ratings-119122800870_1.html).

<sup>83</sup> Himadri Buch, *SEBI mulls linking fund managers' remuneration to scheme performance*, MONEYCONTROL (May 28, 2019), <https://www.moneycontrol.com/news/business/mutual-funds/sebi-mulls-linking-fund-managers-remuneration-to-scheme-performance-4026001.html>.

Firstly, it may be made compulsory for funds to calculate the duration period of floating rate bonds by using the maturity date of the bonds, rather than the dates for the reset in their interest rates. This would give investors clarity regarding the duration of floating rate bonds and enable them to understand when they would actually obtain their invested money back.

Secondly, to ensure that the provision of side-pocketing is not taken advantage of, SEBI can prescribe the conditions or thresholds under which the side pocket can be created. In case, despite the set provisions, a fund house chooses to not create a side pocket, it should be required to give reasons for the same and explain how it aims to recover from the defaulting assets, so as to ensure that unitholders are not exposed to more loss. Such involvement of SEBI and increased accountability on the part of fund houses can help in ensuring investor protection.

Moreover, unlisted bonds can be shifted into a segregated fund. This would be similar to side-pocketing and would prevent the value of these unrealisable bonds from being reflected in the NAV of the scheme, which would ultimately allow the investors to be informed about what can be traded. Unlike side-pocketing, however, this would not run the risk of poor investment decisions being hidden, as the bonds would ultimately yield results at maturity, only not through sale earlier.

Further, investments in perpetual bonds with no put option, like Additional Tier 1 bonds, may be disallowed completely in those mutual fund schemes that have a fixed time period of maturity, since they have no fixed redemption period and the choice of redeeming lies completely with the bond issuer. Hence, investors' freedom to withdraw their money would not be put at risk through the inclusion of such bonds in short-term schemes, and arbitrary callbacks by bond issuers would be prevented.



SEBI also needs to further streamline the categorization of schemes and reduce complexity in the same. This is especially true for debt MFs, which have a total of 16 sub-categories - too many for investors to adequately understand. The criteria of classification could also be improvised, for instance by using both the credit profile and the duration of the paper to categorize funds in order to prevent fund managers from mislabelling or repackaging funds and taking credit risks in funds where they should not. Further, SEBI may keep a closer check on the classifications of their schemes made by mutual fund houses to prevent mistakes or defaults in the same.

Additionally, the disclosure process may be improved. International standards for security markets dictate that disclosures to investors by issuers should be made in a clear and comprehensible manner, along with being timely and accurate, so that they enable investors to understand the risks and procedures involved in investing and make informed decisions.<sup>84</sup> These principles may be better complied with through stricter supervision of the disclosures by SEBI or fund trustees and insistence of greater quality of the same.

Another suggestion is for the asset-gathering oriented compensation structure to be modified to drive mutual fund managers towards ensuring safety and good performance of schemes, rather than focusing on bringing in more AUM, by adopting an income structure based on the performance of the fund. This move had also been considered by SEBI in 2019.<sup>85</sup> Some fear that this may lead to desperation to perform and undertaking short-term risks to improve performance, but that could possibly be combated

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<sup>84</sup> International Organisation of Securities Commission, *Objectives and Principles of Securities Regulations*, 24, 36, IOSCO.ORG (May, 2003), <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>.

<sup>85</sup> Himadri Buch, *SEBI mulls linking fund managers' remuneration to scheme performance*, MONEYCONTROL (May 28, 2019), <https://www.moneycontrol.com/news/business/mutual-funds/sebi-mulls-linking-fund-managers-remuneration-to-scheme-performance-4026001.html>.

by considering a long-term performance approach, rather than rewarding short-term gains. Studies have also revealed that performance-based pay is directly associated with superior fund performance, and thus the measure could improve the functioning of the mutual fund market as a whole.<sup>86</sup> The authors believe that such a measure could enable the shift of priority of the fund managers to improving the performance of the fund, making the industry more investor-friendly.

Lastly, reforms regarding credit rating agencies may be introduced. While SEBI has continued to introduce reforms to the regulatory framework surrounding CRAs, especially following the cases of defaults, the 'issuer pays' model may need to be changed in order to bring about major development. One alternative is having investors pay a part of the fee, thus absolving the CRAs' sole dependence on issuers for money. Another option is to have all rating fees paid by issuers into a common fund overseen by the regulator. The rating fee paid to the CRA would then be deducted from the funds raised and credited to a 'bond rating fees fund account' overseen by the regulator. This would also help in curbing the practice of 'rating shopping', though it can have its cons since the regulator may acquire excessive control over the process, which may lead to more red-tapeism.<sup>87</sup> Further, it should perhaps be made mandatory that all rating exercises conducted by an issuer be disclosed, and no choice be given to an issuer or a CRA to abort a rating exercise except in extraordinary circumstances. Additionally,

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<sup>86</sup> Linlin Ma et al., *Portfolio manager compensation and mutual fund performance*, Finance Down Under 2014 Building on the Best from the Cellars of Finance, Research Collection Lee Kong Chian School of Business (May 13, 2016), [https://ink.library.smu.edu.sg/lkcsb\\_research/5169](https://ink.library.smu.edu.sg/lkcsb_research/5169).

<sup>87</sup> Dhruva Purkayastha, Raghuttama Rao, *Reforming the Credit Rating Industry in India*, HINDU BUSINESS LINE (Aug. 21, 2019), <https://www.thehindubusinessline.com/opinion/columns/reforming-the-credit-rating-industry-in-india/article29183225.ece>.

while SEBI has advised mutual funds to conduct their own rating processes, this could be made mandatory to reduce dependency on uncertain third-party ratings.

Hence, the suggested measures can contribute to closing the existing gaps in the regulatory structure and ensure a safer market for the investors.

## VII. CONCLUSION

From the initial days of UTI to the eventual introduction of public and private players and, over time, the increasing growth of the industry and the corresponding increase in more comprehensive rules and regulations, the mutual fund industry in India has had a long journey. SEBI has stepped up as an able regulator and made fervent efforts to streamline the market mechanisms and inject greater levels of transparency, accountability, efficiency, and investor protection into it.

At the same time, the recurrence of financial crises like the one involving Franklin Templeton urges SEBI to continually rethink its steps and work towards greater regulatory change to mitigate the effects of such crises and combat the recurring mismanagements in a complex industry such as this. This approach allowed the industry to quickly stabilise itself post the crisis in 2020, with 72 lakh folios being added to the industry, debt-oriented scheme folios rising by 15.84 lakhs, and the AUM surging by 17% to reach Rs. 31 lakh crores in the past year.<sup>88</sup> Some of the still persisting loopholes in the regulatory structure, which are used by the fund houses to their advantage and expose investors to undue risk, have been analysed in this paper. They should be adequately addressed and acted upon

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<sup>88</sup> *Mutual funds continued to attract investors in 2020, at 72 lakh folios*, THE ECONOMIC TIMES (Jan. 24, 2021, 7:04 PM), <https://economictimes.indiatimes.com/mf/mf-news/mutual-funds-continue-to-attract-investors-in-2020-add-72-lakh-folios/articleshow/80435402.cms?from=mdr>.

through appropriate measures like those suggested, to bring about regulatory evolution that further boosts the growth of the industry and the economy.

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## A HOLISTIC STUDY OF THE LEGALITY OF PAY-FOR-DELAY AGREEMENTS – AN INDIAN PERSPECTIVE

- Nishant Pande\* & Urja Dhapre\*

### ABSTRACT

*Patent protection functions as an incentive for drug manufacturers to undertake extensive research and trials in order to create an innovative product. Over the years, drug manufacturers have devised mechanisms to extend this statutory protection of their invention, which is called evergreening. In India, the operation of Section 3(d) of the Indian Patent Act, 1970 prevents the possibility of evergreening by way of secondary patents. However, one of the upcoming measures used by drug manufacturers to extend patent protection is pay-for-delay agreements or reserve payment settlements which do not have a clear legal position in India, both from an intellectual property law and competition law perspective. These settlements work in an uncanny scheme wherein two extreme players i.e. the innovator company and the generic company come together in conjunction under the aegis of a settlement, thereby giving the regulators genuine reasons for concern and suspecting their agreement to legal culpabilities. With this background, the article examines evergreening, particularly pay-for-delay agreements, from the lens of intellectual property law, contract law and competition law. Keeping in mind the objective of innovation and public welfare, this article also attempts to define the contours of the approach that can be followed by the Indian regulators to curb the schemes of market players trying to extend their exclusive rights by unfair means. For this purpose, this paper also scrutinises the position of law in other mature jurisdictions around the globe. Finally, this paper attempts to*

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*extrapolate the provision of compulsory licensing as a measure that can be resorted to by the government in light of Covid-19.*

**Keywords:** Intellectual Property Rights, Patents, Pay-for-delay agreements, Competition Law, Contract Law

## I. INTRODUCTION

The essence of the Indian Patents Act, 1970 (“**Patents Act**”)<sup>1</sup> is based on the fragile balance between incentivising the innovator by providing exclusivity to her product in the market for a limited time, and maintaining consumer welfare with affordable prices of these products.<sup>2</sup> Amongst all, India’s pharmaceutical sector stands rigid in its ability to accept and implement this purpose of law. The same can be understood by the fact that for a pharmaceutical company to invent a drug, it has to undergo a complicated procedure of research, recognition, clinical trials and promotion.<sup>3</sup> Moreover, the cost of creating a new drug is incredibly high accompanied by a risk of failure at every step.<sup>4</sup> Years of hard work behind a drug, with a huge risk of uncertainty, if approved by the Patent Office, shields a company’s drug by an exclusivity of 20 years.<sup>5</sup> Towards the end of this exclusivity, the drug prices nosedive heavily owing to the generic competition entering the market, and is generally referred to as the ‘patent cliff.’<sup>6</sup>

For a pharmaceutical company, these 20 years may not suffice its quest to prolong the monopoly achieved by building market dominance. Consequentially, unearthing any and all plausible routes of extending the life of a drug’s patent protection seems imperative to a company for securing the profitability of a drug.<sup>7</sup> Companies devise

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<sup>1</sup> The Patents Act, 1970, No. 39, Acts of Parliament, 1970 (India).

<sup>2</sup> Justice N. Rajgopala Ayyangar, *Report on The Revision of The Patents Law*, SCC ONLINE ¶481 (Sept. 1959), [https://ipindia.gov.in/writereaddata/Portal/Images/pdf/1959-Justice\\_N\\_R\\_Ayyangar\\_committee\\_report.pdf](https://ipindia.gov.in/writereaddata/Portal/Images/pdf/1959-Justice_N_R_Ayyangar_committee_report.pdf).

<sup>3</sup> Jing Chen et al., *Drug Discovery And Drug Marketing With The Critical Roles Of Modern Administration*, 10 (12) AM. J. OF TRANSL. RES. 4302, 4302 (2018).

<sup>4</sup> *Id.*

<sup>5</sup> The Patents Act, 1970, No. 39, Acts of Parliament, 1970, §53.

<sup>6</sup> Chie Hoon Song & Jeung-Whan Han, *Patent Cliff And Strategic Switch: Exploring Strategic Design Possibilities In The Pharmaceutical Industry*, 5 (1) SPRINGER PLUS 692, 693 (2016).

<sup>7</sup> Himanshu Gupta et al., *Patent Protection Strategies*, 2(1) J.PHARM & BIO ALLIED SCI. 2, 2-3 (2010).

strategies to operationalize the time gap between its patent expiration date and the entry of generic manufacturers. This practice of continuing the patent protection or extending monopoly over an already approved patent is called 'evergreening'.

Evergreening is usually consummated by resorting to one of the following practices<sup>8</sup>-

- a) Fabricating entry barriers;
- b) Developing and patenting a minor variant of the same drug;
- c) Delaying generic entries; and
- d) Weakening the competition and/or strengthening own competitive strengths when the dominant position is threatened.

These strategies are typically resorted to in the pharmaceutical industry when a monopoly of 20 years is about to expire,<sup>9</sup> thereby defeating the purpose of the Patents Act. In India, only the scheme of secondary patenting has been explored, wherein the companies acquire supplementary patents as an addition to original patents that protect the original drug's underlying active ingredient.<sup>10</sup> The secondary patents safeguard the outlying features of the drug, such as the tablet's covering,<sup>11</sup> which peripherally improves only the evident application of the originally invented drug.

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<sup>8</sup> Hoon Song, *supra* note 8 at 695.

<sup>9</sup> Arun Kumar & Arun Nanda, *Ever-greening in Pharmaceuticals: Strategies, Consequences and Provisions for Prevention in USA, EU, India and Other Countries*. *Pharmaceutical Regulatory Affairs*, 6(1) PHARM REG. AFF. 1, 2-5 (2017).

<sup>10</sup> Bhaven N. Sampat & Kenneth C. Shadlen, *Indian Pharmaceutical Patent Prosecution: The Changing Role of Section 3(d)*, 13 PLOS ONE 1, 4 (2018).

<sup>11</sup> *Astra Aktiebolag v. Andrx Pharmaceuticals*, 222 F.Supp. 2d 423 (2002) (USA).



Pay-for-delay agreements are still at a nascent stage with no recognized ruling by the Indian Courts. The avenues of non-patent based means of evergreening have not been brought under the regulatory lens of the Patents Act. These means include the marketing of branded products after the patent protection has expired wherein the branded drug manufacturers make use of strategies and merchandising tools to maintain sales and attenuate the effect followed by generic entry (off-patent products)<sup>12</sup> and reverse settlements (pay-for-delay settlements).<sup>13</sup> This paper examines the latter of the non-patent based strategies by scrutinising the intersection of intellectual property rights law, contract law and competition law.

## II. PURPOSE OF ENTERING INTO PAY-FOR-DELAY AGREEMENTS

A patent protecting a developed drug compensates the originator's innovation by providing her with a free reign over the market for a time frame of 20 years.<sup>14</sup> On the contrary, it is expected that the innovators reap the benefits of their discovery within the life of this patent protection. The constant fear of generic manufacturers fraying into the market with cheaper versions and driving prices down at any point in this period instigates the originator to deliberately delay the entry of such manufacturers by binding them in an agreement.<sup>15</sup> This method of artificial extension of an originator's patent protection is referred to as 'pay-for-delay agreements' or 'reverse settlements'.<sup>16</sup> The agreement is orchestrated by the brand-name pharmaceutical company ("patentee") to pay off its generic competitor in return for a promise of holding her

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<sup>12</sup> Ove Granstrand & Frank Tietze, *IP Strategies and Policies for and Against Evergreening*, 4 CTM WORKING PAPER 2014, UNIVERSITY OF CAMBRIDGE1, 27(2015).

<sup>13</sup> C Scott Hemphill & Mark Lamley, *Earning Exclusivity: Generic Drug Incentives and the Hatch-Waxman Act*, 77 ANTITRUST L. J. 947, 966(2011).

<sup>14</sup> *supra* note 5.

<sup>15</sup> *Pay-For-Delay: When Drug Companies Agree Not To Compete*, FEDERAL TRADE COMMISSION, <https://www.ftc.gov/news-events/media-resources/mergers-competition/pay-delay>.

<sup>16</sup> *Id.*

product off the market for a negotiated time period.<sup>17</sup> These agreements are fruitful for both the patentee and its competitors; brand-name pharmaceutical drug prices stay high and the generic competitor shares the benefits of the brand's continuous monopoly profits.<sup>18</sup>

The existing cases on pay-for-delay agreements, particularly in the United States ("US"), have stemmed out of lawsuits brought in by the originator claiming patent infringement and the same being later settled out of court by paying off the generic manufacturer.<sup>19</sup>

By fending off the generic manufacturer, the originator extends the life of her drug by a specific time. As the patentee's market exclusivity is extended, this patent evergreening strategy thwarts the generic manufacturers from publishing reverse-engineered versions of already patented drugs.<sup>20</sup> Generic drugs are cheaper than their original branded counterparts, partly because their manufacturers need not invest in marketing drugs or developing them,<sup>21</sup> but also because the introduction of these drugs leads to a competition of price between various drug manufacturers.<sup>22</sup> Hence, a measure like pay-for-delay agreements that impede the entry of generic drugs into the

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<sup>17</sup> Gregory H Jones et al., *Strategies that delay or prevent the timely availability of affordable generic drugs in the United States*, 127(11) BLOOD 1398, 1401 (2016).

<sup>18</sup> *Pay-for-Delay: How Drug Company Pay-Offs Cost Consumers Billions*, FEDERAL TRADE COMMISSION (Jan. 2010), <https://www.ftc.gov/sites/default/files/documents/reports/pay-delay-how-drug-company-pay-offs-cost-consumers-billions-federal-trade-commission-staff-study/100112payfordelayrpt.pdf>.

<sup>19</sup> Federal Trade Commission v. Actavis Inc., 570 US 136 (2013) (USA).

<sup>20</sup> Rajarshi Banerjee, *The Success of, and Response to, India's Law against Patent Layering*, 54 H. INT'L L. J. 204, 211 (2013).

<sup>21</sup> Ranit Mishori, *Why are generic drugs cheaper than brand-name ones?*, WASHINGTON POST (Jul. 11, 2011), [http://www.washingtonpost.com/national/health-science/why-are-generic-drugs-cheaper-than-brand-name-ones/2011/07/05/gIQAwZdL9H\\_story.html](http://www.washingtonpost.com/national/health-science/why-are-generic-drugs-cheaper-than-brand-name-ones/2011/07/05/gIQAwZdL9H_story.html).

<sup>22</sup> Henry G. Grabowski & Margaret Kyle, *Generic Competition and Market Exclusivity Periods in Pharmaceuticals*, 27 MANAGERIAL DECISION ECON. 491, 491 (2007).

pharmaceutical market keep drug costs as much as 90 percent higher<sup>23</sup> for consumers, and, consequently, limit their access to what can be life-saving treatments.<sup>24</sup>

### III. THE LACUNA IN THE INDIAN PATENTS ACT

While significant safeguards have been kept in place to curb the practice of evergreening, the Indian Patents Act is not yet fully equipped to deter innovators from using shrewd strategies to exploit the loopholes of Patent Laws in order to maximize monopoly over their already patented drugs and retain exclusivity.

#### A. *The interplay of pay-for-delay agreements and the Patents Act*

The effect of these pay-for-delay agreements on the consumers contradicts the objective of the Trade-Related Aspects of Intellectual Property Rights (“TRIPS”) agreement<sup>25</sup> and the purpose of the Patents Act. The contradiction can be witnessed by looking at the preamble of the TRIPS which states, “to recognize the underlying public policy objectives of national systems for the protection of intellectual property, including developmental and technological objectives.”<sup>17</sup> Simultaneously, the purpose behind the enactment of the Patents Act was not to fortify the innovator to enjoy the monopoly of his patented products, but to prioritise and protect the public interests.<sup>26</sup>

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<sup>23</sup> *Pay-For-Delay: How Drug Company Pay-Offs Cost Consumers Billions*, FEDERAL TRADE COMMISSION, <https://www.ftc.gov/sites/default/files/documents/reports/pay-delay-how-drug-company-pay-offs-cost-consumers-billions-federal-trade-commission-staff-study/100112payfordelayrpt.pdf>.

<sup>24</sup> Alfred B. Engelberg, *A Shortfall In Innovation Is The Cause Of High Drug Prices*, Health Affairs Blog (Feb. 28, 2019), <https://www.healthaffairs.org/doi/10.1377/hblog20190228.636555/full/>.

<sup>25</sup> TRIPS: Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, 1869 U.N.T.S. 299, 33 I.L.M. 1197 (1994).

<sup>26</sup> Amiya Kumar Bagchi et al., *Indian Patents Act and Its Relation to Technological Development in India: A Preliminary Investigation*, 19(7) E.P.W. 287, 292 (1984); Stephen

The Patents Act is primarily based on the recommendations of the Ayyangar committee,<sup>27</sup> and its purpose is accentuated by Section 83 of the Patents Act, which intends to ensure that the purpose of granting patents is to make the patented invention reach the public at affordable prices and not to let the patentee have a monopoly over its invention.<sup>28</sup> It secures the right granted by the patent to not be abused by resorting to practices which unreasonably restrict trade. The same can be corroborated by two patent decisions<sup>29</sup> namely, Indian patent application numbers 1079/KOL/2009<sup>30</sup> and 852/KOL/2010<sup>31</sup>, passed by Kolkata Patent Office, wherein the Controller rejected both the patent applications under Section 83(a)<sup>32</sup> and (g)<sup>33</sup> of the Patents Act. The Controller ironed out the interpretation of Section 83 in both the applications by stating that the import of biological material, which was otherwise available in India on commercial sale, can make the product unaffordable in India, thereby defeating the inherent intent of Section 83.

The concept of evergreening started in India with innovators seeking to reset the 20 year period by consequently filing patents that are slight

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Barnes, *Pharmaceutical Patents and TRIPS: A Comparison of India and South Africa*, 91 KY. L.J., 911, 920 (2003).

<sup>27</sup> *supra* note 4.

<sup>28</sup> The Patents Act, 1970, No. 39, Acts of Parliament, 1970, §83(a) and 83(g).

<sup>29</sup> Dr. Amitavo Mitra, *Controller overreach or common sense? - A tale of Section 83 of the Patents Act*, LAKSHMIKUMARAN & SRIDHARAN ATTORNEYS (Aug. 23, 2016), <https://www.lakshmisri.com/insights/articles/controller-overreach-or-common-sense-a-tale-of-section-83-of-the-patents-act/>; *CII Recommendations on Issues Associated with Biodiversity Law and Its Compliance*, CONFEDERATION OF INDIAN INDUSTRY, <http://ciipharma.in/pdf/Biodiversity-Law-and-Its-Compliance-Booklet.pdf>.

<sup>30</sup> Patent App. No. 1079/KOL/2009.

<sup>31</sup> Patent App. No. 852/KOL/2010.

<sup>32</sup> Section 83(a) of the Patents Act reads as – “that patents are granted to encourage inventions and to secure that the inventions are worked in India on a commercial scale and to the fullest extent that is reasonably practicable without undue delay”.

<sup>33</sup> Section 83(g) of the Patents Act reads as – “that patents are granted to make the benefit of the patented invention available at reasonably affordable prices to the public”.

variants of the active ingredient, also called as secondary patent or follow-up patents.<sup>34</sup> An amicable outlook has not been displayed by India towards innovators instrumentalising shrewd evergreening strategies to extend the life of their drug's patent protection like that of secondary patenting.<sup>35</sup>

Evergreening by filing secondary patents is not easy in India due to the operation of Section 3(d) of The Patents Act. It clearly defines the threshold for secondary patents on drugs as therapeutic efficacy of a substance, where applicants may need to supply some clinical evidence, averting the patentability of salts, esters, ethers, polymorphs etc.<sup>36</sup> The Madras High Court in the case of *Novartis AG v. UOI* ("Novartis")<sup>37</sup>, by taking into consideration the threshold of secondary patenting, stated that,

*"We have borne in mind the object which the Amending Act wanted to achieve namely, to prevent evergreening; to provide easy access to the citizens of this country to life saving drugs and to discharge their Constitutional obligation of providing good health care to its citizens."*<sup>38</sup>

The Court declined to grant a patent protection, and on appeal to the Supreme Court of India ("SC"), the Madras High Court's decision was upheld.<sup>39</sup>

While the practice of secondary patenting is not welcomed in India, the United States of America ("US") and the European Union ("EU") take a lenient approach when it comes to the use of secondary patents.<sup>40</sup>

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<sup>34</sup> *Novartis AG v. Union of India*, 2007 AIR 24759 (Madras HC).

<sup>35</sup> The Patents Act, 1970, No. 39, Acts of Parliament, 1970, §3(d).

<sup>36</sup> *Id.*

<sup>37</sup> *Novartis AG*, 2007 AIR 24759.

<sup>38</sup> *Novartis AG*, 2007 AIR 24759.

<sup>39</sup> *Novartis AG v. Union of India*, (2013) 6 SCC 1.

<sup>40</sup> Jennifer Anna Sellin, *Does One Size Fit All? Patents, the Right to Health and Access to Medicines*, 62 NETH. INT'L L. R. 445, 466 (2015).

The quintessential instance to understand secondary patenting is that of the best-selling prescription drug in the U.S., 'Humira' which<sup>41</sup> has enjoyed 39 more years of patent protection by way of 247 subsequent patent applications; this being in addition to the 76 patent applications in the EU and 63 in Japan. While Humira costs \$1,300 (₹85,000) in the US, on the flipside, it costs only \$200 (₹13,500) in India owing to the rejection of secondary patents on Humira by the Indian Patent Office ("IPO") in India and the subsequent entry of cheaper versions.<sup>42</sup>

India, being rightly called the *pharmacy of the world*, focuses more on the implication that evergreening bears on public health, which is negative with respect to these agreements.<sup>43</sup> India, unlike other countries,<sup>44</sup> has a strong lobby against including data exclusivity and patent extension provisions for pharmaceuticals and agro-chemical sectors. These exclusions stimulate the interest of the generic industries and the insertion of such provisions will have a huge significance on the generic industry, resulting in the delayed entry of cheaper versions of already patented branded drugs.<sup>45</sup>

Recently, the Delhi High Court ("DHC") ruled on similar lines against the plaintiff, by rejecting his claim for a trade secret protection of his product whose patent protection in US had expired and further

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<sup>41</sup>Overpatented, Overpriced:How Excessive Pharmaceutical Patenting is Extending Monopolies and Driving up Drug Practices, I-MAK, <http://www.i-mak.org/wp-content/uploads/2018/08/I-MAK-Overpatented-Overpriced-Report.pdf>.

<sup>42</sup> Feroz Ali & Sudarsan Rajagopal, *Biologics, Patents And Drug Prices*, THE HINDU (Feb. 08, 2018), <https://www.thehindu.com/opinion/op-ed/biologics-patents-and-drug-prices/article22682251.ece>.

<sup>43</sup> *supra* note 42 at 446.

<sup>44</sup> Amit Singh & Paramita Das Gupta, *Pharmaceutical Test Data Protection and Demands for Data-Exclusivity: Issues and Concerns of Developing Countries and India's Position*, 24 J. INT. PROP. R. 69, 73 (2019).

<sup>45</sup> Jaya Bhatnagar & Vidisha Garg, *India: Data Exclusivity*, MONDAQ (May 21, 2009), <https://www.mondaq.com/india/information-security-risk-management/79418/data-exclusivity>.

had no subsisting patent protection in India.<sup>46</sup> The court observed that the defendants cannot be restrained from manufacturing the product because of the claimed confidential information already available in the public domain. It further stated that anything construed to the contrary would otherwise amount to the judicial creation of an extra-statutory monopoly for perpetuity in the invention. The same can defeat the scheme and purpose of the Patents Act, that encourages to bring an invention to public domain after the expiry of the term of the patent, and which is opposed to public interest as well as to judicial discipline.

Corollary to the analysis of the scheme of the Patents Act and evergreening nuanced above, it can be conclusively understood how the Indian courts' approach will play out while interpreting pay-for-delay agreements. While at one end the issue of these agreements being anti-competitive has been adjudicated upon in various jurisdictions, the evergreening aspect of these agreements has not yet been ventured into by the authorities around the globe.

The regulatory framework of the Patents Act currently, is such that it creates a deterrent only for the evergreening strategy of secondary patents being filed. The structure is such that a flexible pay-for-delay agreement can be used to defeat the purpose of curbing evergreening along with providing affordable healthcare to the consumers. Thus, pay-for-delay agreements are useful strategies with legitimate application to provide profitability to the patentee. However, these agreements are increasingly being subject to scrutiny by regulators for potential anti-competitive conduct.<sup>47</sup>

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<sup>46</sup> Claudio De Simone v. Actial Farmaceutica SRL, MANU/DE/0841/2020.

<sup>47</sup> Federal Trade Commission v. Actavis Inc., 570 US 136 (2013) (USA); Case T-472/13, Lundbeck Ltd. v. European Commission ECLI:EU:T:2016:449 (EU); T-691/14 Servier and Others v. Commission ECLI:EU:T:2018:922 (EU); Case C-307/18 Generics (UK) Ltd v. Competition and Markets Authority ECLI:EU:C:2020:52 (EU).

Consequently, under the Indian patent law regime, these pay-for-delay agreements can be used to instrumentalise evergreening thereby affecting consumer ability to afford medicines, a consequence which the Indian regulators have always despised.<sup>48</sup>

*B. Implications in the Indian patent law regime*

The judgement of Novartis was heralded by a lot of countries as India was leading by example in restraining evergreening, thereby protecting access to public health.<sup>49</sup> However, despite India's stringent measures, the practice of secondary patenting is still rampant in India<sup>50</sup> as pharmaceutical companies have their schemes in place to overcome anti-evergreening provisions of the Patents Act.<sup>51</sup> Proactively, pay-for-delay agreements being one of the schemes employed by patentees to extend monopoly, needs to be regulated. In contrast to the EU and the US, which have set their arrangements to detect such suspected agreements, India is yet to devise a method to regulate these pay-for-delay settlements.<sup>52</sup> Although these settlements are not illegal, the Indian courts have time and again directed parties engaged in patent infringement suits to opt for mediation as a viable route for reaching affable settlements;<sup>53</sup> a remedy which is often the instigation for these

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<sup>48</sup> *supra* note 42.

<sup>49</sup> Dorothy Du, *Novartis Ag v. Union of India: "Evergreening," Trips, and "Enhanced Efficacy" under Section 3(d)*, 21 J. Intell. Prop. L. 223, 256 (2014).

<sup>50</sup> Feroz Ali & Sudarsan Rajagopal, *Rampant evergreening in Indian pharma industry*, LIVEMINT (Apr. 30, 2018, 04:42 PM), <https://www.livemint.com/Opinion/aIqAgfMWLyel1uPEfEcEtI/Rampant-evergreening-in-Indian-pharma-industry.html>.

<sup>51</sup> Sampat, *supra* note 12 at 7.

<sup>52</sup> Njideka Chukwu, *Regulatory Responses Against Reverse Payment Agreements in the Pharmaceutical Industry*, 6(2) INTELLECTUAL PROPERTY BRIEF161, 184 (2015).

<sup>53</sup> C.H. Unnikrishnan, *CCI to scan drug patent settlements*, LIVEMINT (Aug. 03 2014, 11:40 PM), <https://www.livemint.com/Companies/RVVDhRh7oTfpqllphkb6jM/CCI-to-scan-drug-patent-settlements.html>; Singh & Associates, *India: CCI To Scan Drug Patent Settlements*, MONDAQ (Oct. 14, 2014), <https://www.mondaq.com/india/patent/346682/cci-to-scan-drug-patent-settlements>.



agreements. Scholars, in furtherance to the same, have pointed out that albeit an out-of-court settlement can give both sides some respite from the prolonged judicial process involved in patent litigation, it can also impair access to affordable medicines.<sup>54</sup>

A different perspective can be put forth by the case of *F Hoffman La Roche v. Cipla Ltd*<sup>55</sup>, wherein Cipla sought to withdraw the Special Leave Petition it had filed in the SC against the DHC's order of 2015 after a long litigation battle. The Apex Court allowed Cipla to withdraw its petition owing to a settlement reached between the parties, with Cipla acknowledging the validity of Roche's patent rights for 'Erlotinib Hydrochloride'. This was one of the significant cases wherein mediation/settlement was firstly recommended by the DHC but had failed. It's surprising to note that after a series of litigation ensued, with the single judge bench of the DHC ruling against Roche and later the same being overturned by the Division Bench of the DHC, Cipla settled even after having a strong case against Roche at such a later stage.

The authors feel the need for settlements like the ones between Roche and Cipla to be scrutinised under both the Patents Act and the Competition Act. Additionally, a detailed examination of the circumstances, terms and conditions of every patent settlement should be conducted. A bizarrely high payment made to the generic manufacturer can turn out to be a covert deal, causing a stir in the already set anti-competitive and anti-evergreening provisions. Moreover, a transparent reporting system can also be initiated to detect pay-for-delay settlements. This would require reporting to the IPO settlement/arrangements between the patentee and the generic pharmaceutical companies that have an impact on the timing of market entry for a generic version of a product into the Indian market.

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<sup>54</sup> *Id.*

<sup>55</sup> *F Hoffman La Roche v. Cipla Ltd*, 2008 DLT 598.

To minimise transition costs and compliance, monitoring of arrangements can be based on the measures employed by the US Federal Trade Commission (“FTC”).<sup>56</sup> The US has implemented a system wherein if the patentee and the generic company enter into a settlement, they have to provide the Department of Justice and the FTC with copies of their settlement agreement within ten days of the settlement execution.<sup>57</sup> Moreover, the enforcement policies of the Competition Commission of India (“CCI”) are likely to be parallel to that of the FTC in US because of a codified Memorandum of Understanding<sup>58</sup> in place so as to advance cooperation and communication between both the agencies.

*C. Compulsory Licencing: a cure for the menace of evergreening*

The Indian patent law is quite distinct from the patent law regimes all around the globe. A part of this distinction lies in the entitlement of any third party to evince that the patented product is not running parallel to the public benefit in so much of it being unaffordable. This right granted to any person, after the expiry of three years is called as Compulsory Licencing under Section 84 of the Patents Act.<sup>59</sup>

Conversely, a license can be also be granted to the generic manufacturer by the willingness of the patentee, often called as

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<sup>56</sup> *supra* note 43.

<sup>57</sup> Christopher Kew, *Patently Uncertain: Developments in Pay-For-Delay Agreements in Australia*, IN COMPETITION (Jun. 11, 2020), <https://incompetition.com.au/2020/06/patently-uncertain-developments-in-pay-for-delay-agreements-in-australia/#page=1>.

<sup>58</sup> *FTC and DOJ Sign Memorandum of Understanding With Indian Competition Authorities*, FEDERAL TRADE COMMISSION (Sept. 27, 2012) <http://www.ftc.gov/news-events/press-releases/2012/09/ftc-doj-sign-memorandum-understanding-indian-competition>.

<sup>59</sup> *supra* note 3.

voluntary licencing for an authorised use of the patented product without the intervention of the governmental bodies.<sup>60</sup>

While the instances of voluntary licencing are not very common in India, compulsory licences are recognised as a useful remedy against the abuse of patent right,<sup>61</sup> by commercial exploitation, and to address the issue of public health in India.

As per Section 84 of the Patents Act, 1970,

*“At any time after the expiration of three years from the date of the grant of a patent, any person interested may make an application to the Controller for grant of compulsory licence on patent on any of the following:*

- *That the reasonable requirements of the public with respect to the patented invention have not been satisfied, or*
- *That the invention which is patented is not available to the public at a reasonably affordable price, or*
- *That the patented invention is not worked in the territory of India.”<sup>62</sup>*

In 2012, India issued its first compulsory license to Natco Pharma for the generic production of Bayer Corporation's lifesaving medicine 'Nexavar'. Natco Pharma, through its generic versions offered to sell Nexavar for a publicly affordable price of Rs. 9,000 compared to its original price of Rs. 2.8 lakhs for each month's dosage. The abovementioned three conditions under Section 84 of the Patents Act

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<sup>60</sup> Deli Yang, *Compulsory Licensing: For Better or For Worse, the Done Deal Lies in the Balance*, 17 J.I.P.R.76, 77(2011).

<sup>61</sup> *Draft Reference Document on the Exception Regarding Compulsory Licensing*, WORLD INTELLECTUAL PROPERTY ORGANIZATION (May 21, 2019), [https://www.wipo.int/edocs/mdocs/scp/en/scp\\_30/scp\\_30\\_3-main1.pdf](https://www.wipo.int/edocs/mdocs/scp/en/scp_30/scp_30_3-main1.pdf).

were fulfilled and the judgement was delivered in the favour of Natco Pharma.<sup>63</sup>

Further, in the judgement of *Novartis Ag v. Cipla Ltd*,<sup>64</sup> the court brought a fine balance between the monopoly of an inventor and the public action by stating that public interest is not a complete exception to the rights granted by the sovereign towards monopoly. The ground of public interest can be invoked once the court finds that the damage is an adequate relief. It is thus clear that the courts do not simply put the public interest before the rightly earned monopoly of the inventor. They look into the whole case, the strength of the patentee's case and that of the defendant's, and then make a justified decision.

Recently, the DHC in *Koninklijke Electronics v. Rajesh Bansal* had ruled that the provision of compulsory licencing in the Patent Act and the anti-competitive practices in the Competition Act is to be read in conjunction with each other. Though the controller can evaluate the competition effects of a patentee's content, if the CCI discovers that the patentee had engaged in anti-competitive practices, the controller cannot refute the same and has to proceed further.<sup>65</sup>

Moreover, the General Court of EU, brought forward a novel viewpoint where it observed that issuing a licensing agreement following the settlement agreement refutes the manifestation of a reverse payment.<sup>66</sup> The burden of proof lies on the competition authority to establish that the royalty paid by the generic manufacturer to the innovator company is peculiarly low and that the transaction was not terminated at an arm's length. The authority needs to prove that the

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<sup>63</sup> Bayer Corporation v. Natco Pharma Ltd., Order No. 45/2013 (Intellectual Property Appellate Board, Chennai).

<sup>64</sup> Bayer Corporation, Order No. 45/2013.

<sup>65</sup> *Koninklijke Philips Electronics N.V. v. Rajesh Bansal*, MANU/DE/2436/2018.

<sup>66</sup> T-691/14, *Servier and others v Commission*, EU:T:2018:922.

royalty persuaded the generic manufacturer to accept the provisions relating to delay in its entry or lowering its marketing in the settlement agreement.

The authors believe that the contemporary procedure for acquiring a remedy in cases of pay-for-delay agreements will be to first avail redressal from the CCI and after that separately file for an application to the controller for compulsory licensing. This makes the process of seeking remedy a long ordeal. The overriding effect of the Competition Act curtails the possibility of any conflict between the Patent Act's provision of compulsory licensing and the Competition Act.<sup>67</sup>

#### IV. THE LEGALITY OF PAY-FOR-DELAY AGREEMENTS UNDER OTHER LAWS

In the preceding part, the authors shed light on the patent law aspect of pay-for-delay agreements, however, pay-for-delay agreements cannot be viewed solely viewed from the lens of patent law and a multi-faceted enquiry is requisite to understand these agreements' legal implications. Thus, under this part, the authors shall discuss how pay-for-delays can be analysed under contract law and competition law.

##### A. Under the Indian Contract Act, 1872

Pay-for-delay agreements fundamentally comprise of acts/omissions promised by two parties. Needless to say, in India, the legal enforceability and validity of these agreements would be tested on the touchstone of the Indian Contract Act, 1872<sup>68</sup> ("**Contract Act**"). Parties are at freedom to choose who they enter in to an agreement with and also to fix the terms of the same.<sup>69</sup> This freedom, however, is not absolute in nature and the law can impose restrictions on the parties entering the

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<sup>67</sup> The Competition Act, 2002, No. 12, Acts of Parliament, 2003, §60.

<sup>68</sup> Indian Contract Act, 1872, No. 9, Acts of Imperial Legislative Council, 1872 (British India).

<sup>69</sup> Her Highness Maharani Shantidevi P Gaikwad v. Savjibhai Haribhai Patel, (2001) 5 SCC 101; Patel Engg. Ltd. v. Union of India, (2012) 11 SCC 257.

agreement as is apparent from Sections 23-30 of the Contract Act; out of which, Sections 23 and 27 can possibly invalidate pay-for-delay agreements.

i. Section 23

Section 23 declares what kinds of considerations and objects are unlawful. One of the facets under this Section is ‘public policy’, as can be gathered from the text of the Section presented hereunder –

*“23. What considerations and objects are lawful, and what not. —  
The consideration or object of an agreement is lawful, unless —*

...

*the Court regards it as immoral, or opposed to public policy.*

*In each of these cases, the consideration or object of an agreement is said to be unlawful. Every agreement of which the object or consideration is unlawful is void.”*

(emphasis supplied)

The expression ‘public policy’ is wide and is incapable of a precise definition<sup>70</sup> and as its meaning changes over time, transactions which were considered against policy at some point in history are, in the present day, being upheld as valid contracts.<sup>71</sup> To curb the menace of the expression’s extrapolation,<sup>72</sup> courts are expected not to invent new

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<sup>70</sup> State of Rajasthan v. Basant Nahata, (2005) 12 SCC 77.

<sup>71</sup> SIR DINSHAW FARDUNJI MULLA, THE INDIAN CONTRACT ACT 107 (Anirudh Wadhwa eds., 15th ed. 2019).

<sup>72</sup> It is noteworthy that the Hon’ble Supreme Court in Central Inland Water Transport Corp. Ltd. v. Brojo Nath Ganguly, AIR 1986 SC 1571, has observed that new heads of public policy can be construed in certain circumstances.

heads of public policy.<sup>73</sup> The pre-established heads of public policy include trading with the enemy,<sup>74</sup> stifling prosecution,<sup>75</sup> interference with the course of justice,<sup>76</sup> procurement of marriages for reward,<sup>77</sup> sale of public office,<sup>78</sup> agreement tending to create monopolies,<sup>79</sup> etc.

As has already been discussed in Part II of this paper, pay-for-delay agreements assist patent-holders to maintain their monopoly status in the market even after the expiration of the statutory protection to their patent.<sup>80</sup> It would not be incorrect to state that pay-for-delay agreements are indeed agreements which tend to create a monopoly in the market and could, therefore, be found contrary to Section 23. Consequently, this illegality of the agreement's object would render the contract unenforceable.

While it is true that the erstwhile Monopolies and Restrictive Trade Practices Act, 1969<sup>81</sup> and current Competition Act, 2002<sup>82</sup> ("**Competition Act**") are special enactments dealing with creation of monopolies and, as special laws prevail over general laws,<sup>83</sup> the general provision under Section 23 would technically stand superseded. This reasoning is further

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<sup>73</sup> *Shrinivasdas Lakshmi Narayan v. Ramchandra Ramrattandas*, (1920) 44 Bom 6; *Abdul Rahim v. Raghunath Sukul*, AIR 1931 Pat 22.

<sup>74</sup> *Jason v. Driefontein Consolidated Mines*, [1902] AC 484 (UK).

<sup>75</sup> *Williams v. Bayley*, (1866) LR 1 HL 200 (UK).

<sup>76</sup> *Rattan Chand Hira Chand v. Askar Nawaz Jung*, (1991) 3 SCC 67.

<sup>77</sup> *Purshotamdas Tribhovandas v. Purushotamdas Mangaldas*, (1897) 21 Bom 23.

<sup>78</sup> *Kappu Gurukul v. Dora Sami*, (1822) 6 Mad 76.

<sup>79</sup> *Somu Pillai v. The Municipal Council, Mayavaram*, (1905) 28 Mad 520; *Devi Dayal v. Narain*, AIR 1928 Lah 33; *District Board, Jhelum v. Hari Chand*, AIR 1934 Lah 474; *Kameshwar Singh v. Mahomed Yasin Khan*, AIR 1938 Pat 473.

<sup>80</sup> *Mishori*, *supra* note 23.

<sup>81</sup> The Monopolies and Restrictive Trade Practices Act, 1969, No. 54, Acts of Parliament, 1969 (India).

<sup>82</sup> The Competition Act, 2002, No. 12, Acts of Parliament, 2003 (India).

<sup>83</sup> *Sharat Babu Digumarti v. Govt. of NCT of Delhi*, 2016 SCC Online SC 1464; *Sarwan Singh v. Kasturi Lal*, (1977) 1 SCC 750.

augmented by a bare reading of Section 60 of the Competition Act which dictates –

*“Act to have overriding effect*

*60. The provisions of this Act shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force.”*

However, the question of the application of the maxim *generalia specialibus non derogant* (i.e., general words do not derogate from special provisions) has been addressed when the matter relates to there being an overriding effect between two enactments which arises in case of a conflict between them.<sup>84</sup> One of the purposes of the Competition Act is to prevent monopolisation in a market as can be seen from the factors of determining Appreciable Adverse Effect on Competition (“AAEC”) under Section 19(3) of the Competition Act,<sup>85</sup> which instructs the Competition Commission of India (“CCI”) to assess (a) creation of entry barriers in the market, (b) driving out of existing competitors from the market, (c) foreclosure of competition, etc. Thus, because of this harmony between the two enactments, there lies no repugnancy between Section 23 of the Contract Act and the Competition Act.

ii. Section 27

The text of Section 27 of the Contract Act is as follows –

*“Agreement in restraint of trade, void. — Every agreement by which any one is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void....”*

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<sup>84</sup> Sharat Babu Digumarti, 2016 SCC Online SC 1464; Shri Ram Narain v. Simla Banking & Industrial Co. Ltd, AIR 1956 SC 614.

<sup>85</sup> The Competition Act, 2002, No. 12, Acts of Parliament, 2003 (India).



Generally, the concept of restraint of trade is viewed from the lens of employment agreements and the restraints scrutinised under it include restraints during the subsistence of service<sup>86</sup> and restraints which operate beyond the term of service.<sup>87</sup> In *IEC School of Art & Fashion v. Mr. Gursharan Goyal*,<sup>88</sup> the DHC found that a restraint of trade may come in many forms and it might be present in clauses relating to goodwill, agreements between competitors, partnership agreements, and employment agreements. This finding has been reiterated in the *Wipro Limited v. Beckman Coulter International S.A*<sup>89</sup> decision of 2006.

In 1894, the United Kingdom's House of Lords observed that a restraint of trade should be assessed while being mindful of the protection to private party in whose favour the condition is being imposed, but such a condition cannot be, in any way, injurious to the public.<sup>90</sup> In the midst of the 20<sup>th</sup> century, this two-pronged approach was still considered legally sound as can be seen in Lord Justice Denning's opinion in *Petrofina (Great Britain) Ltd v. Martin*.<sup>91</sup> Further, in the landmark decision of *Esso Petroleum Co. Ltd. v. Harper's Garage (Stourport) Ltd.*,<sup>92</sup> the protection of both private and public interests were again weighed by the majority of the judges. Basing the analysis of a restraint of trade agreement on injury suffered by the public can be justified both at an economic and a social point of view.<sup>93</sup>

This outlook towards restraint of trade is not limited just to the United Kingdom. In India, in the case of *M/s. Lalbhai Dalpatbhai & Co. v.*

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<sup>86</sup> *Niranjan Shankar Golikari v. Century Spinning & Mfg Co Ltd.*, AIR 1967 SC 1098.

<sup>87</sup> *Superintendence Company of India v. Krishan Murgai*, AIR 1980 SC 1717.

<sup>88</sup> *IEC School of Art & Fashion v. Mr. Gursharan Goyal*, 72 (1998) DLT 833.

<sup>89</sup> *Wipro Limited v. Beckman Coulter International S.A*, 2006 SCC OnLine Del 743.

<sup>90</sup> *Nordenfelt v. Maxim Nordenfett Gunsand Ammunition*, [1894] AC 535.

<sup>91</sup> *Petrofina (Great Britain) Ltd v. Martin* 1965 (2) All ER 176.

<sup>92</sup> *Esso Petroleum Co. Ltd. v. Harper's Garage (Stourport) Ltd.*, [1968] AC 269.

<sup>93</sup> MICHAEL J. TREBILCOCK, *THE COMMON LAW OF RESTRAINT OF TRADE: A LEGAL AND ECONOMIC ANALYSIS* 142 (Sweet & Maxwell, London, 1986).

*Chittaranjan Chandulal Pandya*,<sup>94</sup> the Gujarat High Court, while appraising a negative covenant, held that restraint must be

*“reasonable in reference to the interest of the contracting parties and secondly it must be reasonable in reference to the interest of the public.”*

The court added that reasonability in reference to public interest meant that the restraint should not harm the public in any way whatsoever.

While dealing with an issue of availability of pharmaceutical products to the public, the DHC has, in its recent decision reported as *Eisai Co. Ltd. v. Satish Reddy*,<sup>95</sup> found that supply of drugs, particularly life-saving drugs, has critical underpinnings in public interest. This public interest was considered so pivotal that it far outweighed the plaintiff's request for relief.

Pay-for-delay agreements, by their very nature, are restrictive agreements between competitors which not only keep the prices of drugs high for the public but also limit the potential of generic drug manufacturers to manufacture substitutes to the patented drug. Thus, from the preceding discussion and the precedents cited, there lies a clear possibility to bring pay-for-delay agreements under the ambit of void restraints under Section 27 of the Contract Act on account of the injury to the public because of its resultant exorbitantly high prices of drugs. All in all, because of the possibilities of monopoly creation and of harm to the public, pay-for-delay agreements may peradventure fall foul of both Section 23 and Section 27 of the Contract Act, 1872.

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<sup>94</sup> M/s. Lalbhai Dalpatbhai & Co. v. Chittaranjan Chandulal Pandya, AIR 1966 Guj 189.

<sup>95</sup> *Eisai Co. Ltd. v. Satish Reddy*, 2019 (79) PTC 568.

### *B. Under the Competition Act, 2002*

The CCI is a relatively new regulator which was created in 2003 by way of the Competition Act.<sup>96</sup> Naturally, the jurisprudence laid by the CCI is not as vast and elaborate as its counterparts from other jurisdictions. As of now, the CCI has neither been faced with information alleging anticompetitive effects of pay-for-delay agreements nor has it taken cognisance of any such agreement on its own accord.<sup>97</sup> Notably, in 2014, it was reported that the CCI was likely to scrutinise three patent settlements involving foreign and local drug manufacturers because their agreements could have impeded access to cheaper alternative drug,<sup>98</sup> but the current status of these enquiries are unknown. Many competition regulators from across the globe have previously investigated the legality of pay-for-delay agreements<sup>99</sup> and hence, it is imperative to theorise the manner in which the CCI can plausibly deal with such agreements.

#### *i. Jurisdiction of the CCI*

Before exploring the potential avenues before the CCI, its jurisdiction to deal with matters lying in the realm of another field of law, *i.e.*, intellectual property rights (“IPRs”), needs to be analysed, as pay-for-delay agreements involve patents which are regulated under the Patents

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<sup>96</sup> The Competition Act, 2002, No. 12, Acts of Parliament, 2003 (India).

<sup>97</sup> Twinkle Chawla & Ruchi Verma, *Pay for Delay Agreements: Antitrust Watch Intensifies*, 5(I) J.N.L.U.D. 22, 31 (2018).

<sup>98</sup> Singh & Associates, *India: CCI To Scan Drug Patent Settlements*, MONDAQ (Oct. 14, 2014), <https://www.mondaq.com/india/patent/346682/ci-to-scan-drug-patent-settlements>; C.H. Unnikrishnan, *CCI to scan drug patent settlements*, LIVEMINT (Aug. 03, 2014, 11:40 PM), <https://www.livemint.com/Companies/RVVDhRh7oTfpqIphkb6jM/CCI-to-scan-drug-patent-settlements.html>.

<sup>99</sup> Federal Trade Commission v. Actavis Inc., 570 US 136 (2013) (USA); Case T-472/13, Lundbeck Ltd. v. European Commission ECLI:EU:T:2016:449 (EU); T-691/14 Servier v. Commission ECLI:EU:T:2018:922 (EU); Case C-307/18 Generics (UK) Ltd v. Competition and Markets Authority ECLI:EU:C:2020:52 (EU).

Act.<sup>100</sup> In *Telefonaktiebolaget LM Ericsson v. Competition Commission of India*,<sup>101</sup> the plaintiff claimed that the CCI was *ultra vires* in passing an investigation order as the subject matter of the dispute was in relation to patents. The DHC found that the remedies under Section 27<sup>102</sup> of the Competition Act and Section 84<sup>103</sup> of the Patents Act were not mutually exclusive. The CCI was at the liberty to adjudicate upon information revealing abuse of dominance in respect of rights conferred under the Patents Act.

The SC, in *Competition Commission of India v. Bharti Airtel Limited*,<sup>104</sup> opined that the presence of Telecom Regulatory Authority of India (“TRAI”) as the sectoral regulator in telecom sector would not oust the CCI’s jurisdiction to deal with anti-competitive practices in that sector. CCI’s jurisdiction stood deferred until the TRAI enquired and formed conclusions because the SC wanted to avoid the possibility of contradictory views on the subject matter. That being said, the court clarified that the holding in the present case could not be relied upon to infer that the CCI’s jurisdiction would always be deferred in cases wherein another regulator could simultaneously exercise jurisdiction.

The DHC’s recent decision in *Monsanto Holdings Pvt. Ltd. v. Competition Commission of India*<sup>105</sup> provides much required clarity regarding the application of Supreme Court’s *Bharti Airtel*<sup>106</sup> decision. TRAI is both a regulator and a controller in the telecom industry, which the DHC differentiated from the Controller of Patents under the Patents

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<sup>100</sup> *supra* note 3.

<sup>101</sup> *Telefonaktiebolaget LM Ericsson v. Competition Commission Of India*, 2016 SCC OnLine Del 1951.

<sup>102</sup> The Competition Act, 2002, No. 12, Acts of Parliament, 2003, §27.

<sup>103</sup> *supra* note 3.

<sup>104</sup> *Competition Commission of India v. Bharti Airtel Limited*, AIR 2019 SC 113.

<sup>105</sup> *Monsanto Holdings Pvt. Ltd. v. Competition Commission of India*, 2020 SCC Online Del 598.

<sup>106</sup> *Bharti Airtel Limited*, AIR 2019 SC 113.

Act. It was found that the Supreme Court's dictum could not be relied about to oust or defer the jurisdiction of the CCI in the present case, *inter alia*, because –

- a) The Controller of Patents was a regulator of patents and it was neither a sectoral regulator like the TRAI nor was its ambit of regulation as “*pervasive*” as the TRAI's regulation, and
- b) The Controller of Patents did not undertake necessary technical considerations which the CCI could not examine.

A reference to the DHC's decisions in *Telefonaktiebolaget LM Ericsson*<sup>107</sup> and *Monsanto Holdings Pvt. Ltd.*<sup>108</sup> makes it amply clear that the CCI's jurisdiction cannot be ousted or deferred inasmuch as probing anti-competitive activities relating to patents is concerned. This can logically be extended to conclude the CCI's competence to look into patent settlements by way of pay-for-delay agreements.

(ii) The effect of the IPR exemption under Section 3(5), Competition Act

Section 3(5) of the Competition Act and the proposed Section 4(A) of the Competition (Amendment) Bill, 2020<sup>109</sup> (“**Competition Bill**”) exempt the application of Section 3 and Section 4 respectively to matters concerning IPRs. Though the Competition Bill would omit Section 3(5) and replace it with Section 4(A),<sup>110</sup> the purpose and language of both Sections are congruent. As can be gathered from the text of the proposed Section 4(A), this exemption makes Sections 3 and 4 inapplicable when

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<sup>107</sup> *Telefonaktiebolaget LM Ericsson v. Competition Commission of India*, 2016 SCC Online Del 1951.

<sup>108</sup> *Monsanto Holdings Pvt. Ltd.*, 2020 SCC Online Del 598.

<sup>109</sup> Draft Competition (Amendment) Act, 2020, <http://feedapp.mca.gov.in/pdf/Draft-Competition-Amendment-Bill-2020.pdf>.

<sup>110</sup> Section 3(5) was only applicable to Section 3 of the Competition Act, 2002, but Section 4(A) shall apply to both Sections 3 and 4 of the Competition Act, 2002.

IPR holders restrain any infringement of their IPR rights<sup>111</sup> [this inapplicability is hereinafter referred to as “**IPR exemption**”).

One of the most prominent orders which dealt with the interpretation of Section 3(5) is *Shri Shamsher Kataria v. Honda Siel Cars India Ltd.*<sup>112</sup> In this matter, the CCI assessed the validity of the car manufacturers’ mandate to original equipment suppliers (“**OESs**”) and authorised dealers to source spare parts exclusively from the original equipment manufacturers (“**OEMs**”). *Inter alia*, the OEMs submitted that IPR exemption permitted persons or enterprises to impose reasonable restrictions to protect their IPRs. The CCI opined that, for an agreement to fall under the ambit of Section 3(5)(i), it is important to consider –

- a) “*whether the right which is put forward is correctly characterized as protecting an intellectual property; and*
- b) *whether the requirements of the law granting the IPRs are in fact being satisfied.*”

While interpreting the text of Section 3(5)(i), the CCI concluded that the IPR exemption which allowed for the imposition of “...*reasonable conditions, as may be necessary for protection of any of his rights*” was qualified by the word “*necessary*”. Thus, the relevant enquiry to assess a restriction under Section 3(5)(i) would be to analyse if the IPR holder would be able to protect her IPR even if the restriction was not enacted.

An understanding of ‘reasonable’ can be derived from *Department of Agriculture, Cooperation & Farmers v. M/s Mahyco Monsanto Biotech (India) Limited.*<sup>113</sup> In this matter, the opposing party had imposed several

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<sup>111</sup> As conferred by IPR statutes (viz. the Copyright Act, 1957 (14 of 1957), the Patents Act, 1970 (39 of 1970), the Designs Act, 2000 (16 of 2000), et al.)

<sup>112</sup> *Shamsher Kataria v. Honda Siel Cars India Ltd.*, 2014 CompLR 1.

<sup>113</sup> *Department of Agriculture, Cooperation & Farmers v. M/s Mahyco Monsanto Biotech (India) Limited*, MANU/CO/0013/2016.

conditions on the sub-licensees of its Bt cotton technology. One of the informant's allegations was that these sub-licence agreements violated Section 3(4) of the Competition Act. The CCI found that the opposing party's strict termination conditions in the sub-licence agreements were not 'reasonable' conditions to protect its IPRs and, thus, the IPR exemption could not be relied upon to thwart the challenge under Section 3.

In the 2016 order in *K. Sera Sera Digital Cinema Pvt. Ltd. v. Digital Cinema Initiatives, LLC*,<sup>114</sup> the CCI was faced with the question of whether the opposing parties had formed a cartel to monopolise the digital cinema exhibition market of India. After the Competition Appellate Tribunal ("COMPAT") set-aside the CCI's initial order and remitted the matter,<sup>115</sup> the CCI observed that the opposing parties' insistence to use DCI-complaint equipment was for the purpose of preventing piracy of movies and the same was a reasonable condition to ensure the protection of IPRs. Though the COMPAT subsequently set aside this order of the CCI, it did not make any observations regarding the scope of the IPR exemption under Section 3(5)(i).<sup>116</sup> Interestingly, in *K. Sera Sera Digital Cinema Ltd. and Pen India Ltd.*,<sup>117</sup> in a similar fact scenario to the previous *K. Sera Sera* case,<sup>118</sup> the CCI again held that the restrictions imposed by the opposing parties to protect their movie from piracy were reasonable as per the IPR exemption.

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<sup>114</sup> *K. Sera Sera Digital Cinema Pvt. Ltd. v. Digital Cinema Initiatives, LLC*, 2016 CompLR 1098.

<sup>115</sup> *K. Sera Sera Digital Cinema Pvt. Ltd. v. Digital Cinema Initiatives, LLC*, 2016 CompLR 180.

<sup>116</sup> *K. Sera Sera Digital Cinema Pvt. Ltd. v. Digital Cinema Initiatives, LLC*, 2016 CompLR 1260.

<sup>117</sup> *K. Sera Sera Digital Cinema Ltd. and Pen India Ltd.*, 2017 CompLR 574.

<sup>118</sup> *supra* note 116.

The recent *Monsanto Holdings Pvt. Ltd. v. Competition Commission of India*<sup>119</sup> decision reveals that, similar to the CCI's understanding, the DHC has also found merit in the argument that the right to impose conditions to prevent an IPR infringement is not unqualified. The condition imposed by the IPR holder must be reasonable for it to be protected under the safe harbour of Section 3(5). Furthermore, it was observed that a patentee is "*not free to include onerous conditions under the guise of protecting its rights.*"

Relying on the aforementioned orders/decisions makes it evident that the right being protected by way of the restriction should pertain to the IPR and such a restriction should be reasonable. Section 53 of the Patents Act dictates that IPR protection would extend only up to 20 years from the date of filing of the patent application. In a pay-for-delay agreement, the restriction of the agreement allows the patentee to extend the life of patent protection beyond the 20 year cap contemplated by the Patents Act and this extension cannot be said to be protecting the IPR as it is in derogation to the statutory time limit of the protection. Thus, there is no requirement to even test the reasonableness of the restriction imposed by the patentee. It can be safely concluded that the IPR exemption cannot be relied upon by patentees to foil the CCI's enquiry into their pay-for-delay agreements.

ii. Inferences from the CCI's study on the Indian pharmaceutical industry

In 2010, the CCI published a study on the pharmaceutical market which was titled 'Competition Law and Indian Pharmaceutical

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<sup>119</sup> *Monsanto Holdings Pvt. Ltd. v. Competition Commission of India*, 2020 SCC Online Del 598.



Industry' ("Market Study").<sup>120</sup> This Market Study also examined the theoretical aspects of pay-for-delay agreements in the domain of competition law. Though the findings of this Market Study are not binding on the CCI, they do shed some light on the regulator's opinions on the matters covered thereunder.

The Market Study finds that patent protection does not culminate into a situation where the patent remains unchallenged, but pay-for-delay agreements provide such protection to the patentee. This is considered to come "*at the expense of the consumers, whose access to lower-priced generic drugs is delayed, sometimes for many years.*" The Market Study categorically found that pay-for-delay agreements amount to market allocation which is *per se* illegal as per Section 3(3)(c) of the Competition Act. Moreover, settlements by way of pay-for-delay agreements were observed to have become recurrent in the pharmaceutical industry because of the courts' lenient outlook towards them. That being said, not all such settlements are liable to be deemed unfavourable as some of them may attenuate waste of resources in litigation.

iii. Scrutinising pay-for-delay agreements under the Competition Act, 2002

As has already been established that the CCI can exercise jurisdiction over pay-for-delay agreements and also that the IPR exemption shall not bar the CCI from looking into the anti-competitive aspects of these agreements, this sub-part presents a hypothesis as to how the CCI can counter these agreements under the Competition Act.

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<sup>120</sup> Centre for Trade and Development (Centad), *Competition Law and Indian Pharmaceutical Industry*, COMPETITION COMMISSION OF INDIA (2010), [https://www.cci.gov.in/sites/default/files/PharmInd230611\\_0.pdf](https://www.cci.gov.in/sites/default/files/PharmInd230611_0.pdf).

Before discussing the CCI's avenues of assessing pay-for-delay agreements, it is essential to highlight its statutory duties as enumerated under Section 18 of the Competition Act, which makes the competition regulator duty-bound to –

*“...eliminate practices having adverse effect on competition, promote and sustain competition, protect the interests of consumers and ensure freedom of trade carried on by other participants”.*

The CCI has held that Section 18 requires that consumers' surplus is not negatively impacted.<sup>121</sup> Healthy competition would not only promote productive and allocative efficiencies for the sellers, but it shall also optimise consumer surplus and that is the reason the CCI is committed to preventing disadvantages to consumers because of unfair or discriminatory prices of the sellers.

In *Shri Sharad Kumar Jhunjunwala v. Union of India*,<sup>122</sup> even when there was no violation of the Competition Act, the CCI, in pursuance of its objective of consumer welfare under Section 18, stated that it hopes and trusts that the Indian Railways does away with service charges on e-ticket bookings as the same went against the interest of the consumers. In *Mr. G. Krishnamurthy v. Karnataka Film Chamber of Commerce*,<sup>123</sup> the CCI found that a cartel to boycott certain kinds of movies also led to consumer harm because of the resultant reduction in consumer choice.

In these cases, the CCI has not shied away from expecting authorities to conduct their affairs in synchronisation with consumer interest. This commitment of the CCI creates a milieu in which it is at least expected if not obligated to assess the anti-competitive effects of pay-for-delay

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<sup>121</sup> *Belaire Owner's Association v. DLF Limited Haryana Urban Development Authority Department of Town and Country Planning*, 2011 CompLR 239.

<sup>122</sup> *Shri Sharad Kumar Jhunjunwala v. Union of India*, (2015) 4 CompLJ 457.

<sup>123</sup> *Mr. G. Krishnamurthy v. Karnataka Film Chamber of Commerce*, 2018 CompLR 907.

agreements because of their obvious consumer harm. The CCI can undertake this assessment by way of two statutory avenues<sup>124</sup> which are as follows.

### Under Section 3 –

Section 3(3)<sup>125</sup> of the Competition Act is applicable to agreements entered into by persons or enterprises who are “*engaged in identical or similar trade of goods or provision of services*”. In other words, it applies to agreements between competitors. Under this Section, the CCI needs to unequivocally establish that there was meeting of minds between the contracting parties to undertake any species of conduct listed under Section 3(3)(a)-(d).<sup>126</sup> It also needs to be shown that the agreed course of action was, in actuality, implemented by the parties.<sup>127</sup> Here, it is imperative to note that the definition of ‘agreement’ i.e., meeting of minds, under the Competition Act is significantly wider than that under the Contract Act, as the former extends to ‘understands’ and ‘arrangements’ as well.<sup>128</sup>

A pay-for-delay agreement is entered into by a patent holder and a generic drug manufacturer; it is apparent that these parties are engaged in an identical/similar trade of goods i.e., manufacture and supply of drugs. A typical pay-for-delay agreement entails an agreement/arrangement between these competitors to delay the generic drug manufacturer’s entry in the market.<sup>129</sup> As the definition of an agreement is very wide under the Competition Act, it would not be difficult for the CCI to discover this agreement/arrangement between

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<sup>124</sup> The CCI can use either or both of these statutory provisions for this assessment.

<sup>125</sup> The Competition Act, 2002, No. 12, Acts of Parliament, 2003 (India).

<sup>126</sup> Director, Supplies & Disposals Haryana v. Shree Cement Limited, 2017 CompLR 97.

<sup>127</sup> In Re: Sugar Mills, MANU/CO/0103/2011.

<sup>128</sup> Director General (Supplies & Disposals) v. M/s. Puja Enterprises Basti, 2013 CompLR 714.

<sup>129</sup> Mishori, *supra* note 23.

these competitors if that agreement pertains to any of the species of conduct listed under Section 3(3)(a)-(d). As a consequence, the *per se* rule under Section 3(3) will apply and there shall be a presumption that the pay-for-delay agreement caused AAEC in the market and the onus to prove that there was no AAEC would be on the parties to the agreement.<sup>130</sup>

Analysing the types of conduct listed under Section 3(3)(a)-(d), the *per se* rule applies to agreements (i) related to price fixing [Section 3(3)(a)]; (ii) limiting/controlling production/supply/technical development etc. [Section 3(3)(b)]; (iii) market allocation [Section 3(3)(c)]; and (iv) bid-rigging [Section 3(3)(d)]. Pay-for-delay agreements can potentially be in contravention of three of these types of conduct *viz.* price fixing, limiting or controlling production or supply or technical development and market allocation. Under Section 3(3)(a), price fixing includes direct as well as indirect price fixing and, thus, the artificial price increase on account of the pay-for-delay settlement would violate Section 3(3)(a). The pay-for-delay settlement would also amount to controlling production or supply or technical development of non-patented drugs as the incentive to compete in the minds of the generic drug manufacturer is extinguished. Interestingly, the CCI's Market Study<sup>131</sup> observed that these agreements could also be curtailed with the use of Section 3(3)(c) as "*they amount to market allocation*", however, the Market Study does not delve into how exactly do such agreements facilitate market allocation.

#### Under Section 4 –

Alternatively, pay-for-delay agreements can be brought under the radar of the CCI under abuse of dominance which is prohibited under

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<sup>130</sup> Express Industry Council of India v. Jet Airways (India) Ltd., 2018 CompLR 376.

<sup>131</sup> *supra* note 122.

Section 4 of the Competition Act. In order to prove that abuse of dominance exists, it needs to be proved that –

- (i) The entity being accused of abuse of dominance is an enterprise,<sup>132</sup>
- (ii) This enterprise was dominant in the relevant market,<sup>133</sup> and
- (iii) Its conduct comprised an abuse under Section 4.<sup>134</sup>

Section 2(h) of the Competition Act<sup>135</sup> provides for the definition of ‘enterprise’ which includes persons engaged in activities related to production, storage, supply, distribution, acquisition or control of articles or goods. Further, Section 2(l) dictates that ‘person’ includes a company, a firm, and anybody corporate. For the purpose of Section 4, the patentee would invariably be constituted as a company or a firm or a body corporate and would, hence, fall under the definition of an ‘enterprise’ susceptible to an abuse of dominance allegation.

The next step would be to show that the patentee was dominant in the relevant market, a pre-requisite for the same is to define the relevant market.<sup>136</sup> The relevant market is defined with reference to the relevant geographical market and relevant product market whilst taking sub-sections (6) and (7) of Section 19 of the Competition Act<sup>137</sup> into account.<sup>138</sup>

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<sup>132</sup> Union of India v. Competition Commission of India, AIR 2012 Del 66.

<sup>133</sup> GKB Hi Tech Lenses Pvt. Ltd. v. Transitions Optical India Pvt. Ltd., MANU/CO/0056/2012.

<sup>134</sup> *Id.*

<sup>135</sup> The Competition Act, 2002, No. 12, Acts of Parliament, 2003, §2(h).

<sup>136</sup> *supra* note 135.

<sup>137</sup> The Competition Act, 2002, No. 12, Acts of Parliament, 2003, §19(6)-(7).

<sup>138</sup> *supra* note 135.

Section 2(s) of the Act defines relevant geographical market as the area where the competition conditions for supply or demand of goods or services are homogeneous and distinguishable from the condition prevailing in the neighbouring areas.<sup>139</sup> In cases of pay-for-delay, the relevant geographical market would most likely be the whole territory of India as the patentee's patented drug would generally be available all across India and there would be no limitations on its supply at a geographical level.

Section 2(t) of the Competition Act<sup>140</sup> defines relevant product market to be composed of all products or services which a consumer considers interchangeable or substitutable on account of the product's or services' characteristics, prices and intended use.<sup>141</sup> In the pharmaceutical sector, the CCI has defined relevant product market at the molecule level i.e. the medicines/formulations based on the same Active Pharmaceutical Ingredient ("API") and each API is a separate relevant product market, as can be determined from the CCI's order of *Biocon Limited v. F. Hoffmann-La Roche AG Konzern-Hauptsitz*.<sup>142</sup> This approach has been taken while defining the market in both enforcement<sup>143</sup> and merger control orders.<sup>144</sup> A patented drug carries certain unique API which is part of the reason it is granted patent protection in the first place.<sup>145</sup> Therefore, the patented drug would constitute its own market while determining the relevant product market. Cumulatively, the relevant market in a Section 4 challenge

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<sup>139</sup> The Competition Act, 2002, No. 12, Acts of Parliament, 2002, §2(s).

<sup>140</sup> The Competition Act, 2002, No. 12, Acts of Parliament, 2003, §2(t).

<sup>141</sup> *South City Group Housing Apartment Owners Association v. Larsen & Toubro Ltd.*, 2013 CompLR 841.

<sup>142</sup> *Biocon Limited v. F. Hoffmann-La Roche AG Konzern-Hauptsitz*, 2017 CompLR 503.

<sup>143</sup> *Biocon Limited*, 2017 CompLR 503.

<sup>144</sup> *Eli Lilly/Novartis AG*, Combination Registration No. C-2015/07/289, dated December 03, 2015; *Sun Pharmaceutical Industries Limited/Ranbaxy Laboratories Limited*, Combination Registration No. C-2014/05/170, dated June 05 2014.

<sup>145</sup> *Sellin*, *supra* note 37.

against a pay-for-delay agreement would be 'the manufacture and sale of the patented drug (with unique API) in the territory of India.'

For the next step, the pre-condition to establish an abuse of dominance by an enterprise is to show that it holds a dominant position in the relevant market.<sup>146</sup>The CCI has, in the matter of *Prasar Bharti (Broadcasting Corp of India) v. TAM Media Research Pvt. Ltd.*,<sup>147</sup> found that an enterprise enjoys dominant position when it has 100% market share along with market conditions acting as entry barriers for new entrants. As the relevant market in a matter pertaining to abuse of dominance through a pay-for-delay agreement would be the manufacturer and sale of the patented drug (with unique API) in the territory of India, it is conspicuous that the patentee would have a 100% market share in the relevant market. Further, as the patentee would have engaged generic drug manufacturers in pay-for-delay agreements to not enter the market and would probably have patent protection when it enters into these agreements, there would clearly be barriers to entry in the market. Resultantly, the CCI would find the patentee in a dominant position in the relevant market.

Subsequent to finding the patentee dominant in the market of the patented drug, it is possible to scrutinise the pay-for-delay under three parts of Section 4 – (i) limiting/restricting production of goods [Section 4(2)(b)(i)]; (ii) limiting/restricting technical or scientific development relating to goods [Section 4(2)(b)(ii)]; and (iii) denial of market access [Section 4(2)(c)]. The pay-for-delay settlement would amount to controlling production or supply or technical development of non-patented drugs as the incentive to compete in the minds of the generic drug manufacturer is extinguished, thus, a violation of Section 4(2)(b)(i) or Section 4(2)(b)(ii) could be established by the CCI. Further, a denial

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<sup>146</sup> *supra* note 135.

<sup>147</sup> *Prasar Bharti (Broadcasting Corp of India) v. TAM Media Research Pvt. Ltd.*, 2016 Comp LR 595.

of market access could also be proved as the dominant patentee would be preventing the generic drug manufacturer's entry into the market of the patented drug.

In summation, if it can be shown that the patentee was indeed in a dominant position in the market of the patented drug, it is highly likely that the CCI could conclude abuse of dominant position on behalf of the patentee.

## V. CONCLUSION

This paper scrutinises the anti-evergreening provisions of the Indian patent law regime and also identifies lacunas in the present law which, in effect, allow patentees to extend their patent protection beyond the statutory limit of 20 years. One of the most malignant measures adopted by patentees is pay-for-delay agreements, the position around which is unclear both under Indian patent law and Indian competition law. This paper outlines the manner in which pay-for-delay agreements are, in spirit, contrary to the patent law regime; it highlights objections from the perspective of contract law and finally, it presents a hypothesis as to how the competition law regulator i.e., the CCI can potentially analyse pay-for-delay agreements.

Currently, the entire world has been combating the effects of COVID-19 for a long period of time and the pursuit of developing a novel vaccine for this novel disease is successful. The Central Drug Control Organisation approved two coronavirus vaccines namely, Covishield and Covaxin. Under such circumstances, a pertinent issue for consideration is the treatment meted out to an innovator's intellectual property rights and the measures adopted by government authorities to balance the situation in case an insufficiency of the vaccine arises in near future.



The abovementioned discussion leads us to conclude that the Indian Patent Act manifests with its restrictive provisions that are cast on a patentee to cater to public health before commercial profits, especially with the economic downturn that the current COVID-19 pandemic has posed. Section 92 of the Patents Act provides an exception to issue compulsory licenses by the government in situations of either national emergency or extreme urgency or in cases of public non-commercial.<sup>148</sup> In these circumstances the government is empowered to not adhere to the elaborate procedure laid down for the grant of a compulsory licence.<sup>149</sup> This authorises the Government of India to provide a compulsory licence for any person applying for a patent to manufacture the drug and ensure that the drug sold reaches the public at the cheapest price possible, while allowing the patentee to derive *reasonable* advantage from its patent rights. The COVID-19 pandemic definitely qualifies as a national emergency and with this, it would be interesting to see what position the government takes and if it avails its powers under the Patents Act to constructively balance its responsibility of protecting public health with the monopoly rights of a patentee.

Conclusively, with the ongoing discourse sparked by the publicised cases of evergreening by these pay-for-delay agreements across the globe, the Indian Patent law regime has not yet adopted any stringent measures to deal with such agreements. The authors are therefore of the opinion that in today's dynamics, prevention can be the best of all remedies and the Indian regulators should be aware of the possible perils and misuses of evergreening resulting from certain usage of pay-for-delay agreements.

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<sup>148</sup> The Patents Act, 1970, No. 39, Acts of Parliament, 1970, §92.

<sup>149</sup> The Patents Act, 1970, No. 39, Acts of Parliament, 1970, §92(3).

SHORT  
ARTICLES

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**EVOLUTION OF PRIMA FACIE SPECIAL EQUITIES IN LIGHT  
OF INTERIM INJUNCTIONS UNDER SECTION 9 OF THE  
ARBITRATION AND CONCILIATION ACT 1996.**

- Priyanshi Sarin\*

**ABSTRACT**

*An injunction, a former writ is a court order which prohibits the continuation of a wrongful act or mandates performance towards restoration/maintenance of status quo.<sup>1</sup> Courts across various jurisdictions have stated the “three-factor test” of prima facie case, the balance of convenience and irreparable harm as the benchmark for granting or refusing injunctions. This paper analyses the varied interpretations of the term “prima facie” by different courts and its application in the judgement Halliburton Offshore Services Limited vs. Vedanta Limited and Another<sup>2</sup>. It also analyses the evolution of “special equities” a newly reiterated ground for grant of an injunction under section 9 of the Arbitration and Conciliation Act (herein referred to as section 9) particularly for restraining invocation of bank guarantees. Lastly, the paper discusses the grey areas in the law with regards to “enforcement of interim orders,” due to which a plaintiff who successfully establishes his case for an injunction is faced with unnecessary stalling of litigation. The central argument of this paper is that the absence of objective guidelines for granting interim injunctions accompanied by weak enforcement mechanisms frustrates the whole process. The author concludes by recommending the need for uniform guidelines by the judiciary accompanied with few amendments in the present injunction regime.*

**Keywords:** Interim Injunction, Prima Facie, Irreparable Harm, Special Equities, Arbitration

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<sup>1</sup> Daniel v. Ferguson (1891) 2 Oh. 27; Hedley v. Webb, (1901) 2 Ch. 126.

<sup>2</sup>Halliburton Offshore Services Limited v. Vedanta Limited (2020) SCC 542 (India).

## I. INTRODUCTION

Interim reliefs are granted to either party before the final adjudication of the dispute. Section 9 of the Arbitration and Conciliation Act, 1996 stipulates the diverse forms of interim reliefs which can be sought before the enforcement of an arbitral award.<sup>3</sup> One such form of relief is the injunction for which courts exercise judicial discretion for granting the same by evaluating the facts and circumstances of each case.<sup>4</sup> Injunctions in the past were granted by the courts of equity,<sup>5</sup> for maintaining the *status quo* of parties until adjudication of final rights and duties, a flexible approach was adopted.<sup>6</sup> The period after merging of the courts of equity with law<sup>7</sup> gave rise to various contradictory judgments on injunction. These inconsistencies prevailed because even though the grounds of granting injunctions are stipulated in statutes, their interpretation varies across different judges. This issue of lack of uniformity which arose in the 20<sup>th</sup> century has now acquired a new dimension; due to the enactment of the Arbitration and Conciliation Act, 1996. Arbitration is an alternate dispute resolution mechanism that aims at limiting court interference and advocates party autonomy.<sup>8</sup> Courts face a dilemma because they are asked to not intervene in arbitration; on the other hand, they are duty-bound to protect the petitioner who shall face irreparable harm, if the court abstains from granting an injunction.

In the present regime, Section 9 can be invoked when there exists an arbitration agreement<sup>9</sup>, an intention of the applicant to take recourse to

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<sup>3</sup> Arbitration and Conciliation Act, No. 33 of 2019, Section 9(1).

<sup>4</sup> Gujarat Bottling Co. Ltd. vs. Coca Cola Co., A.I.R (1995) S.C. 2372 (India).

<sup>5</sup> WILLIAM WILLIAMSON KERR, A TREATISE ON THE LAW AND PRACTICE OF INJUNCTIONS 15 (6th Ed. 1927).

<sup>6</sup> John Leubsdorf, *Standard for Preliminary Injunctions*, 91 HARV. L. REV. 525, 530-31 (1978).

<sup>7</sup> 28 U.S.C. § 723(c) (1934).

<sup>8</sup> Fleur Johns, *Performing Party Autonomy*, 71 LAW & CONTEMPORARY PROBLEMS, 243, 252 (2008)

<sup>9</sup> Ambience Developers & Infrastructure Pvt. Ltd., AIR 2010 NOC 1031 (India).

arbitration proceedings<sup>10</sup>, and most importantly when the relief asked for emanates from the arbitration agreement.<sup>11</sup> Once, the above conditions are satisfied, Courts would assess the petition in light of the grounds of granting temporary injunctions as mentioned under order 39 of the Code of Civil Procedure.<sup>12</sup> The three pillars<sup>13</sup> of granting an injunction under Code of Civil Procedure are the presence of a *prima facie* case, irreparable harm/injustice to the applicant in case injunction is not granted, and lastly whether the balance of convenience is in the plaintiff's favor.<sup>14</sup> Even though these principles are applicable when the court determines a section 9 application<sup>15</sup>, the nature of cases for which they would apply remains contentious. Indian precedents have been influenced by divergent views i.e. whether to admit an application for an injunction based on "*prima facie* triable issue" or whether to examine the case on its "merits". The author argues that for maintaining a balance between courts and arbitral tribunals concerning section 9, specifically injunction applications there is a dire need for the objective exercise of discretion by courts.

## II. SPECIAL EQUITIES

In 1900, Sir John Woodroffe spelled out the term "equities"<sup>16</sup> by stating that "*an injunction will not be granted in the first instance except upon a clear prima facie case and upon positive averments of the equities on which the application for the relief is based.*"<sup>17</sup> After a century, the notion of

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<sup>10</sup> Sundaram Finance Ltd v. NEPC India Ltd., AIR 1999 SC 565 (India).

<sup>11</sup> Sunil Malhotra, *The Law Relating to Interim Measures in the Arbitration & Conciliation Law in India*, INDIAN COUNCIL OF ARB. (2006).

<sup>12</sup> Adhunik Steels Ltd. v. Orissa Manganese and Minerals Pvt. Ltd., (2007) 7 SCC 125 (India).

<sup>13</sup> Dorab Cawasji Warden v. Coomi Sorab Warden and Ors., (1990) 2 SCC 117 (India).

<sup>14</sup> Bloom Decor v. Subash Himat Lal Desai, (1994) 6 SCC 322 (India).

<sup>15</sup> GARY B. BORN, *INTERNATIONAL ARBITRATION: LAW AND PRACTICE*, 209-226 (2nd ed. 2015).

<sup>16</sup> J G WOODROFFE, *THE LAW RELATING TO INJUNCTIONS IN BRITISH INDIA*, 100-102 (1st edn., Thacker, Spink, and Co 1900).

<sup>17</sup> *Id.*

equities has transformed into special equities and is considered to be a ground for granting an injunction in disputes related to bank guarantees. In cases of commercial contracts, a letter of guarantee is issued by banks to the creditor stating that the bank would be liable to pay a stipulated amount (conditional bank guarantee) in case of breach of contract by the debtor. This is an independent contract between the bank and the creditor and the bank is always required to pay the amount, the debtor being a third party has no say in the same.<sup>18</sup> An exception to the same is “fraud” by the creditor and presence of “**special equities**” in favour of the debtor who would then have the right to seek “interim injunction” by the courts to prohibit encashment of money either against the creditor or the bank. Courts generally issue an injunction against the bank for not making the payment of guarantee amount in cases which *prima facie* are unjust and would result in “abuse of rights” such as the unprecedented COVID-19<sup>19</sup>

The term special equities was first coined in the case *Texmaco Ltd. v. State Bank of India*<sup>20</sup> wherein the Calcutta High Court stated that special equities are an exception to the payment of the letter of credit and shall entitle the plaintiff to an injunction restraining performance of bank guarantee. Due to the absence of special equities, the plaintiff was not granted an injunction even though the court did not elaborate upon the scope of special equities. Special equities were elucidated in *BSES Limited v. Fenner India Ltd. and Anr.*<sup>21</sup> as a circumstance where not granting an injunction would cause irretrievable injustice to the party. Thus, special equity as a ground for an interim injunction has a close nexus to irreparable harm and injury.

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<sup>18</sup> Delhi Lotteries v. Rajesh Aggarwal, A.I.R (1998) Del 332 (India).

<sup>19</sup> Binnur Ataseven & Oguz Comert, *Interim Injunction with Regard to Letters of Guarantee*, 22 GSI 58 (2020).

<sup>20</sup> *Texmaco Ltd. v. State Bank of India*, (1979) MANU/WB/0012 (India).

<sup>21</sup> *BSES Limited v. Fenner India Ltd. and Anr.*, (2006) MANU / SC / 0741 (India).

Subsequently, the word “*prima facie*” was attached to special equities and it was observed by the court that injunction should be granted only in serious cases so as to preserve the integrity of trading operations.<sup>22</sup>

Irretrievable injury in case of bank guarantee was pointed out in *Dwarikesh Sugar Industries Ltd. v. Prem Heavy Engineering Works (P) Ltd. and ors.*<sup>23</sup> wherein the Court stated that the nature of circumstances has to be such that it makes it impossible for the guarantor to reimburse himself and the Court must be satisfied that there would be no possible restitution of the party. *Standard Chartered Bank v. Heavy Engineering Corporation Limited*,<sup>24</sup> conceptualized and compartmentalized irretrievable injustice and special equities as distinct circumstances, the existence of either of which would justify an order of injunction. It can be deduced that while some courts treat special equities corollary to irretrievable harm, others believe both of these to be distinct grounds. Further, by analysing the above judgments the author states that the principle of irretrievable injustice or special equities would come into play where either party to a contract having been provided with an internal adjudicative mechanism such as arbitration, attempts to frustrate results of such an internal adjudication by recourse to encashment of bank guarantee. The court as the guardian of citizens would then step in and provide relief to the party at risk.

### III. COVID-19: PRIMA FACIE GROUND FOR INJUNCTION?

In a recent judgement, *Halliburton Offshore Services Limited v. Vedanta Limited and Another*<sup>25</sup>, the Delhi High Court granted an injunction to the plaintiff to refrain the respondent from invoking the clause related to

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<sup>22</sup> Svenska Handelsbanken v. Indian Charge Chrome, (1994) MANU/SC/0138 (India).

<sup>23</sup> Dwarikesh Sugar Industries Ltd. v. Prem Heavy Engineering Works (P) Ltd. and Ors., (1997) MANU/SC/0639 (India).

<sup>24</sup> Standard Chartered Bank v. Heavy Engineering Corporation Limited, AIR 2019 SC 1638 (India).

<sup>25</sup> Halliburton Offshore Services Limited v. Vedanta Limited and Anr., (2020) SCC Del 542 (India).

bank guarantee. The court stated that non-performance of the contract was due to the global pandemic and pointed out the two grounds on which injunction is granted in case of bank guarantees i.e. fraud or presence of *prima facie* “special equities”. In the context of this particular case, the pandemic was deemed as being *prima facie* a force majeure event as sufficient enough ground for granting an injunction. The plaintiff was able to establish that he had made a genuine attempt to fulfil the obligations, there is no adequate remedy available under law and lastly that he is under threat of suffering irreparable harm.

A judgement rendered a month apart from the above case in the case of *Standard Retail Pvt. Ltd. v. M/s. G. S. Global Corp & Ors.*<sup>26</sup> deviated from the *ratio decidendi* of the above case. In this case, petitioners had invoked Section 9 of the Arbitration Act and sought an injunction against the invocation of the Bank guarantee. They claimed “force majeure” and stated that in view of the COVID-19 pandemic and the lockdown, their contracts with Respondent No. 1 were terminated as unenforceable on account of frustration, impossibility and impracticability. The court denied the plaintiff interim relief in the form of an injunction by ruling that Petitioners cannot abstain from fulfilling contractual obligations to Respondent No. 1. The Letters of Credit are an independent transaction with the Respondent Bank and the Respondent Bank is not concerned with underlying disputes between the Petitioners (buyers) and Respondent No. 1 (seller). The Author acknowledges that different High Courts are not bound by each other’s precedents<sup>27</sup> however, the facts of the case are almost identical with the *Halliburton Offshore Services (supra)* case, and yet in one case petitioners are granted an injunction and in the other they are not. The author believes that the development of jurisprudence on “special equities” is extremely important for unravelling such form of uncertainties that cause injustice. In the latter

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<sup>26</sup> *Standard Retail Pvt. Ltd. v. M/s G.S. Global Corp & Ors.*, Commercial Arbitration Petition (L) No. 404 of (2020).

<sup>27</sup> *Valliamma Champaka Pillai v. Sivathanu Pillai and Ors.*, (1979) 4 SCC 429 (India).



judgement, courts adopted a strict “theoretical” perspective, wherein COVID-19 should have been deemed as a ground for granting an injunction.

#### IV. PRIMA FACIE STANDARD

The extensive use of “*prima facie*” at all stages of granting injunction makes it imperative to delve into the true essence of the same. The phrase ‘a *prima facie* case’ literally means ‘at first sight’ and can be legally construed to mean ‘on first appearance but subject to further evidence or information’.<sup>28</sup> Earlier Chancery Courts held that the applicant seeking an injunction must present the grounds for seeking an interim injunction even though the threshold for proving the same is not very high,<sup>29</sup> i.e. it is not necessary to show that the applicant would succeed in the trial.<sup>30</sup> Additionally, courts must exercise fair discretion in determining the validity of applicants’ claims.<sup>31</sup> However, subsequent judgments proved that there is no set parameter for determining the presence of a “*prima facie*” case.

In *Walker v. Jones*<sup>32</sup> Lord Justice Turner stated that:

*“The real point before us upon this appeal is, not how these questions ought to be decided at the hearing of the case, but whether the nature and difficulty of the questions are such that it was proper that the injunction should be granted until the time for deciding them should arrive.”*<sup>33</sup>

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<sup>28</sup> BLACK LAW DICTIONARY (10th edn, West 2014) 2-3, 1909.

<sup>29</sup> J G WOODROFFE, THE LAW RELATING TO INJUNCTIONS IN BRITISH INDIA, 100-102 (1st edn, Thacker, Spink, and Co 1900).

<sup>30</sup> ADRIAN ZUCKERMAN, ZUCKERMAN CIVIL PROCEDURE: PRINCIPLES & PRACTICE (3rd edn, Sweet & Maxwell 2013).

<sup>31</sup> Allahabad Bank v. Rana Sheo Ambar Singh, AIR 1976 All 447 (India).

<sup>32</sup> *Walker v. Jones*, 16 ER 151 (1865)

<sup>33</sup> *Id* 156.

This principle was adopted by the Indian Courts, In *Israil v Samser Rahman*<sup>34</sup> wherein the Calcutta High Court stated:

*“What the Court has, at this stage, to determine is whether there is a bona fide contention between the parties, or... whether there is a fair and substantial question to be decided as to what the rights of the parties are.”*<sup>35</sup>

Later, courts opined that the presence of a serious question of law was not enough, and the probability of success in the suit was necessary for establishing a *prima facie* case.<sup>36</sup> In *Preston v. Luck*<sup>37</sup> the Court of Appeal in England held that the Court must be satisfied that there is a probability that plaintiffs are entitled to relief. A tilt from the presence of a “substantial question” to “probability of relief” was also adopted by the Indian Courts at that period, in *Ismail v. Tayaballi Essaj*<sup>38</sup> the Court vacated an injunction order on grounds that there was no probability of plaintiff attaining relief. Similarly in *Vithal v. Dawoo*<sup>39</sup> the court stated the need for “prejudging a case” before granting an injunction. This principle implies that an injunction shall be denied when in the courts view, the petition lacks any factual or legal issue which warrants court interference. The principle of probability of relief can be exemplified by the ratio laid down in the case of *Gujarat Bottling Co. v. Coca Cola*<sup>40</sup> wherein the Supreme Court stated that:

*“Relief is granted by way of an interlocutory injunction for mitigating risk of injustice to the plaintiff. Discretion is to be exercised by the Court by assessing the presence of a prima facie case, balance of convenience and the risk of irreparable injury to the plaintiff if*

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<sup>34</sup> *Israil v. Samser Rahman*, AIR 1914 Cal 362 (India).

<sup>35</sup> *Id* 364.

<sup>36</sup> *Ismail v. Tayaballi Essaji*, A.I.R 1929 Sind 182 (India).

<sup>37</sup> *Preston v. Luck*, 27 Ch D 497 (1884).

<sup>38</sup> *Ismail v. Tayaballi Essaj*, AIR 1929 Sind 182 (India).

<sup>39</sup> *Vithal v. Dawoo*, AIR 1931 Nag 106 (India).

<sup>40</sup> *M/S Gujarat Bottling Co.Ltd. & Ors. v. The Coca Cola Co. & Ors.*, 1995 SCC (5) 545 (India).

*interlocutory injunction is denied. The object of the interlocutory injunction is to protect the plaintiff against injury by violation of his right for which he could not be adequately compensated in damages recoverable in the action if the uncertainty were resolved in his favour at the trial. The Court must weigh one need against another and determine the "balance of convenience".*

Subsequently, to subvert the prevailing uncertainty, House of Lords for the first time laid some guidelines in the case of *American Cyanamid*.<sup>41</sup> These guidelines were centred around the idea that courts should not adjudge the case on its merits for granting an interim injunction. An injunction should be granted only in those cases wherein providing damages would be an unsatisfactory remedy.<sup>42</sup> These guidelines were further reiterated by the Madhya Pradesh High Court<sup>43</sup> and the Apex court.<sup>44</sup> In *Laxmikant Patel v. Chetanbhai*,<sup>45</sup> Supreme Court held that:

*"a refusal to grant an injunction despite the availability of facts, which are prima facie established by overwhelming evidence and material available on record justifying the grant thereof, occasion a failure of justice".*

The contemporary approach for granting an interim injunction under Section 9, is however different from the above stated flexible approach. In *Transmission Corporation of AP v. Lanco Kondapalli*<sup>46</sup> as well as *M Gurudas v. Rasaranjan*<sup>47</sup> the courts held that to grant an injunction

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<sup>41</sup> *American Cyanamid Co v. Ethicon*, AC 396 (1975).

<sup>42</sup> *Id.*

<sup>43</sup> *Shankarlal Debiprasad v. State of MP*, 1978 MPLJ 419 (India).

<sup>44</sup> *Power Control Appliances v. Sumeet Machines*, (1994) 2 SCC 448 (India); *Colgate Palmolive Ltd. v. Hindustan Unilever Ltd.*, (1999) 7 SCC 1 (India).

<sup>45</sup> *Laxmikant Patel v. Chetanbhai*, (2002) 3 SCC 65, 75 (India).

<sup>46</sup> *Transmission Corporation of AP v. Lanco Kondapalli*, (2006) 1 SCC 540 (India).

<sup>47</sup> *M Gurudas v. Rasaranjan*, (2006) 8 SCC 367 (India).

it is important to assess the strength of the parties i.e. whether the plaintiff is likely to win the suit or not.<sup>48</sup>

The Court in the *Halliburton* decision has not highlighted the exact principles of determining prima facie case; nonetheless, the author believes that it has applied the principle of assessing relative strength and analysed the merits of the case. This principle enumerates the need to decipher probability of a successful injunction claim at the end of the trial. In the recent case of *CRSC Research and Design Institute Group Co. Ltd. v. Dedicated Freight Corridor Corporation of India*<sup>49</sup>, the Delhi High Court has again reinstated this principle by noting down the rounds for granting interim relief in case of a Section 9 Application as follows:

- The existence of a *prima facie* case, the balance of convenience and irreparable loss, justifying such grant of interim relief to the applicant;
- The existence of emergent necessity, so that, if interim protection is not granted by the Court, chance to approach Arbitral Tribunal under Section 17 would be futile.

The second reason which prompts the author towards the notion of analysing merits of the case before the trial is the fact that the courts have ample opportunity to examine all the documentary evidence which are corollary to an interim injunction application. Under the 2002 amendment to the Code of Civil Procedure, parties are conferred with the obligation of filing all possible documents which are even remotely significant for their case.<sup>50</sup> The judge probably inferred the presence of a *prima facie* case by examining the contractual obligation of the plaintiff, his efforts to fulfil the contract and lastly his inability as a result of the pandemic. Moreover, it is bound by the law laid down by Supreme

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<sup>48</sup> *SM v Dyechem v. Cadbury Ltd.*, (2000) 5 SCC 573 (India).

<sup>49</sup> *CRSC Research and Design Institute Group Co. Ltd. v. Dedicated Freight Corridor Corporation of India*, O.M.P. (I) (COMM.) 184/2020 (India).

<sup>50</sup> Civil Procedure Code, Order VIII, Rule 1A.

Court<sup>51</sup> which clearly states that the presence of a *prima facie* case is dependent on examination of pleadings in the documents submitted.<sup>52</sup> Thus, the author feels that the court drifted from the approach which deems the presence of a *prima facie* case based on a “triable issue” because of the 2002 amendment and secondly because not following the precedents would have decided *per incuriam*.<sup>53</sup>

## V. ENFORCEMENT OF INTERIM ORDERS

Order 21 of Code of Civil Procedure applies to the execution of a decree and not orders,<sup>54</sup> thereby an interim order is enforced through Section 94 of the Code of Civil Procedure or Rule 2A of Order 39.<sup>55</sup> Disobedience of an injunction order is punishable under Rule 2A with involuntary attachment of property or civil imprisonment.<sup>56</sup> The author believes that the provision of detention or taking away property is a penalty<sup>57</sup> and not *per se* a mechanism for enforcement. Primarily because it is not providing any relief to the party who sought an injunction. In the present case, even after an injunction is sought against the invocation of bank guarantee, if the respondent breaches the order, the applicant would again have to prove the disobedience before a court. The opponent has ample opportunity to delay and frustrate the entire process of interim relief. Courts have also denied enforcement of injunction under Section 10 of the Contempt of Court Act<sup>58</sup> by stating

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<sup>51</sup> INDIA CONST. art. 141.

<sup>52</sup> Maria Sequeria Fernandez v. Erasmo Jack, 2012 (3) SCALE 550 (India).

<sup>53</sup> Karl Shroff, *Per Incuriam: An analysis*,

<https://www.scconline.com/blog/post/2020/06/02/per-incuriam-an-analysis/>.

<sup>54</sup> Thummu Koti Nagaiah v. D Sambaiah, AIR 1963 AP 136 (India).

<sup>55</sup> Pradeep KN v. The Station House Officer, AIR 2016 Ker 211 (India).

<sup>56</sup> Rattu v. Mvala, AIR 1968 Raj 212; Hiralal v. Popatlal, AIR 1969 Guj 28; Adaikkala v. Imperial Bank, AIR 1926 Mad 574 (India).

<sup>57</sup> Thummu Koti Nagaiah v. D Sambaiah, AIR 1963 AP 136 (India).

<sup>58</sup> Nitinkumar Pramodbhai Pandya v. Spenta Colour Lab Pvt. Ltd., (1996) 1 GLR 14 (India).

that the applicant can resort to the machinery provided under rule 2A of Order 39 of the Code of Civil Procedure.<sup>59</sup>

Thereby, the author recommends the adoption of “dismissal of pleadings” of the defaulting party, this provision would act as a deterrent against notorious parties who aim to defeat the purpose of injunctions and cause irreparable harm to the plaintiff. Dismissal of pleadings by the party which intends to subvert the interim order passed against him would function as a protective shield for the plaintiff. The petitioner is unlawfully prevented from reaping the fruits of an interim order sought by him after immense procedural compliances and satisfying his burden of proof. Thus, to truly render justice and uphold the principle of equity mere provisions and statutes are not enough and should accompany practical enforcement.

## VI. CONCLUSION

The term “special equities” has acquired distinct meanings over the course of time and is often used interchangeably with “irreparable harm”. This is problematic because “special equities” as a ground are used only to restrain invocation of bank guarantee and irretrievable injustice is a statutory ground for granting injunctions, thus the latter applies to all types of subject matters. The author suggests that special equities should be granted statutory recognition and deemed as a fourth ground for granting an injunction. This addition would develop jurisprudence on special equities which would help in distinguishing it from irretrievable harm and limit contradictory judgments on similar facts. Special equities is used in conjunction with *prima facie* case and has a close nexus with irreparable harm and thereby can run parallel to the existing principles. Incorporating special equities would help uphold

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<sup>59</sup> Shaik Mohiddin v. Section Officer, Karnataka Electricity Board, Kaiwara, (1994) Cri.L.J.3689 (India).

the integrity of arbitration agreements and party autonomy since the parties would not be surrounded by an air of subjectivity.

Secondly, it is true that grounds for granting injunctions are to be interpreted by appreciating the facts of a particular case; nonetheless to some extent courts shall attempt to formulate some objective guidelines and approach for determining the presence/absence of a *prima facie* case. The author believes that the court has to give such construction which would avoid hardship, or even repugnancy.<sup>60</sup> As far as the legislature is concerned, it is high time that they strengthen the enforcement laws for interim injunction orders. Lastly, entertaining Section 9 applications for granting injunctions should not be perceived as interference with powers of the arbitral tribunal. There persist situations like the above scenario wherein it becomes inevitable for the courts to intervene during the arbitration process.

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<sup>60</sup> Hindustan Construction Co. Ltd. and Ors. v. Satluj Jal Vidyut Nigam Ltd., (2005) MANU/DE/2969 (India).

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## THE PANOPTICON: FROM BENTHAM, THROUGH FOUCAULT TO THE SURVEILLANCE STATE

- Karan Ahluwalia\*

### ABSTRACT

*Jeremy Bentham was greatly influenced by the Utilitarian moral theory and his effort towards evolving the criminal justice system along those lines was the reason for the creation of what was arguably his magnum opus- the Panopticon. It was a novel architectural design for any institution that housed people requiring supervision- be it children in school, patients in a hospital, workers in a factory or most famously- prisoners in a penitentiary. In the years after his death, the Panopticon assumed a far-more sinister shade for being considered the symbolic premonition of the totalitarian state, chiefly by the hands of noted French Philosopher- Michel Foucault.*

*This article aims at capturing the essence of the Panopticon as envisioned by Bentham in order to understand its metaphorical use by Foucault and how the latter's observations relate to the existence of surveillance states in the 21<sup>st</sup> century. The discussion will progress by examining both sides of the arguments for and against state surveillance before concluding on a note that is aimed at inspiring further research and academic deliberation on the concept of intellectual privacy.*

**Keywords:** Bentham, Foucault, Surveillance, Panopticon, Liberties, Philosophy

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## I. BENTHAM'S PANOPTICON: A SUI GENERIS ARCHITECTURAL DESIGN

Bentham's Panopticon was a "vividly imaginative fusion of architectural form with a social purpose."<sup>1</sup> It was a circular, tiered, honeycomb-shaped building with concentrically placed cells arranged around a central inspection tower. The central inspection tower was to be sized sufficiently large so as to serve as the residence of the inspector and his family, while also affording him the view of each and every cell under his supervision. Each cell had two openings on opposite sides- one facing the inspection tower and the other- outside. Both these openings were to be made of metal bars so as to afford the inspector a clear view of every cell through-and-through.

One of the key features of this construction was that the windows of the inspection tower would be opaque to the prisoners- this meant that the inspector could supervise them at any time without being seen by them. The purpose served by this feature was that prisoners would perpetually be under an eerie feeling of constant observation that would "prevent secretive communications by the prisoners and make chains and other physical restraints superfluous."<sup>2</sup> This unique take on prison management was aimed at reducing the costs of prison administration by enabling them to function with employment of a smaller number of guards.

This prison system was framed around the three principles, *viz.* principles of lenity, severity and economy. An overriding principle of this form of imprisonment was that the suffering of a prisoner, doomed to forced labour for a given period of time, should not be coupled with bodily sufferance<sup>3</sup>. The purpose of imprisonment was not to inflict pain,

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<sup>1</sup> JOHN DINWIDDY, BENTHAM 7 (1<sup>st</sup> ed. 1989).

<sup>2</sup> MICHAEL IGNATIEFF, JUST A MEASURE OF PAIN: THE PENITENTIARY IN THE INDUSTRIAL REVOLUTION 110 (1<sup>st</sup> ed. 1978).

<sup>3</sup> JEREMY BENTHAM, THE PANOPTICON AND POSTSCRIPTS I AND II 112 (John Bowring ed., 1<sup>st</sup> ed. 1962).

rather to cause the birth of a humane person<sup>4</sup>, as such the prisoners had rights: freedom from oppression, hunger, disease and death<sup>5</sup>. Bentham's Panopticon embodied the self-regulating principles of the free market economy by allowing the contractor to make profits from the sale of goods manufactured by the inmates, in exchange for a small allowance that was to be paid to the prisoners for their labour. This ensured that the former had a pecuniary interest in the health and wellbeing of the prisoners under his care.

All things considered, the beauty of Bentham vision lay in its simple exploitation of human vulnerability and insecurity by creating a system where the inspector could "see without being seen"<sup>6</sup> in order to create an efficient institutional system that functioned on the principle of self-regulation. He had created an administrative system that was rehabilitative and was theoretically capable of "punishing the incorrigible, guarding the insane, reforming the vicious, confining the suspected, employing the idle, maintaining the helpless, curing the sick, instructing the willing in any branch of industry, or training the rising race in the path of education."<sup>7</sup>

As in the case of any power-dynamic, the age-old question of "*quis custodiet ipsos custodes*" or "who will watch the watchers" arose- if the inspector was watching the prisoners, who was watching the inspector? Bentham dealt with this issue by providing that the doors of all such institutions be "thrown wide open to the body of the curious at large- the great open committee of the tribunal of the world"<sup>8</sup>; i.e. the institutions were to be open to the general public so that the threat of criticism was always looming over the heads of the prison administration- thereby safeguarding the rights of the prisoners. The

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<sup>4</sup> JANE SEMPLE, *BENTHAM'S PRISON: A STUDY OF THE PANOPTICON* 35 (1<sup>st</sup> ed. 1983).

<sup>5</sup> *Id.* at 44.

<sup>6</sup> BENTHAM, *supra* note 3, at 64.

<sup>7</sup> *Id.* at 40.

<sup>8</sup> *Id.* at 46.

genius of Michele Foucault lies in his ability to transform Bentham's institutional model into a metaphor for the power dynamics between modern governments and their citizens- this aspect is elaborated in Part II.

## II. FOUCAULT'S PANOPTICON: A METAPHORICAL INTERPRETATION

Bentham's Panopticon transformed from an architectural design to a metaphor for society in 1975, with the publication of Michele Foucault's "Discipline and Punish". This book goes to extraordinary lengths to relate the power-dynamic created between the prisoners and warden in the Panopticon, with Foucault's idea of discipline.

He begins with a discussion of all the measures taken by authorities in the 17<sup>th</sup> Century, to contain the spread of the Bubonic Plague in Europe<sup>9</sup>. Entire towns were placed on lock-downs under the authority of a single intendant- who was responsible not only for ensuring that people observed the quarantine, but also for fumigation of homes, distribution of rations, disposal of dead bodies and security. At his disposal, was the power to condemn a person to death for an infraction as simple as stepping out of home without permission. Society was segmented, people were isolated and a detailed record of each person- which included their name, age, sex, condition etc. was maintained by the intendant and his team. Magistrates exercised complete control over treatment, and doctors without prior authorisation could not see patients due to the fear that they would hide the cases of Plague- such was the level of insecurity. Each individual was "constantly located, examined and distributed among the living beings, the sick and the dead – all this constitutes a compact model of the disciplinary mechanism."<sup>10</sup> And so from the chaos of the Plague, arose order and

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<sup>9</sup> MICHEL FOUCAULT, DISCIPLINE & PUNISH: THE BIRTH OF THE PRISON 195-228 (Alan Sheridan tr., 1<sup>st</sup> ed. 1995).

<sup>10</sup> *Id.*

discipline- supervised by the intendant and enforced by the feeling of constantly being under surveillance.

Foucault compared the power dynamics shared by the residents of these European towns with their intendants, with those that existed between the prisoners and their wardens in Bentham's Panopticon. Both relationships functioned on the unease in the minds of those being watched, due to their being in a state of perpetual surveillance by an entity they themselves could not see, a feeling that was used by those in power, to bring order to chaos and reformation to the criminal mind. This is where Foucault introduced the idea of discipline.

Foucault explained what "discipline" meant, as follows:

*"Discipline may be identified neither with an institution nor with an apparatus; it is a type of power, a modality for its exercise, comprising a whole set of instruments, techniques, procedures, levels of application, targets; it is a physics or an anatomy of power, a technology."*<sup>11</sup>

He explained discipline to mean something multi-faceted and diverse in application, modalities of which would depend on various factors such as the nature of the chaos to be remedied, the target group of individuals, the level of application and so on. It was considered an idea that could be enforced- a state of being. The ability to observe, without being observed was the source of power in both Bentham's as well as Foucault's theories on the Panopticon, as a way to enforce discipline.

Foucault's genius lies in the fact that he was able to recognise that visibility is a trap and the real effect of the Panopticon is the abolition of crowds thereby paving the way for a society of individuals. He remarked that the Panoptic principle was much more than simply

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<sup>11</sup> *Id.*

architectural ingenuity or a practical solution to a problem- it was the harbinger of a completely new type of society, using the power of “mind over minds.”<sup>12</sup> His superimposition of the Panopticon on the modern, surveillance state is absolutely in line with Bentham’s assertion that power should be visible and unverifiable. Power is visible when it is symbolically omnipresent in one’s society- as a constant reminder of its existence. In the Panopticon it takes the form of the central watchtower that every inmate could see at all times, and in society the same is symbolised by state emblems, CCTV cameras, military parades and so on. Power must also be unverifiable in the sense that those on whom it could be exercised should believe that this can be done at any time, without being especially aware of when they are and aren’t under observation. This was achieved in the Panopticon through the use of Venetian blinds in the watchtower, preventing inmates from seeing inside and thereby ever finding out whether the inspector was observing them or not. In society, this could be achieved through governmental activities like wire-tapping, e-mail access, web-user profiling among many other covert techniques. The beauty of this design lies in its simplicity, the Panopticon concept automatizes and de-individualizes<sup>13</sup> power in such a manner that the question ‘who exercises this power?’ becomes irrelevant and the only thing that matters is that this power, rather discipline, exists.

### III. PANOPTIC STATE SURVEILLANCE IN THE MODERN ERA

It is no secret that those in power, have always been interested in the affairs of their subjects. The NSA is known to have been working on a large data-processing and supercomputing facility in order to intercept and store much of the world’s internet traffic for analysis and decryption<sup>14</sup>. The existence of such a facility in the heart of the “free

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<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> James Bamford, *The Black Box*, WIRED (Mar. 30, 2012) <https://www.wired.co.uk/article/the-black-box>.

world”- a state that takes pride in being able to afford its citizen the largest basket of civil liberties in the world, is not only ironic but also a cause for serious concern. Such facilities embody the essence of Bentham’s Panopticon in the metaphorical sense that Foucault construed it to be- using the technique of covert surveillance in order to create a power-dynamic between the citizens and their governments.

Surveillance precludes the operation of fair democratic principles for two main reasons. Firstly, it chills the exercise of our civil liberties as it takes away the peoples’ freedoms to think, read, communicate and experiment with new socio-political ideas for the fear that any such activities might be construed as deviant<sup>15</sup>, opening them up to investigation and prosecution by the state. This infringement of “intellectual privacy”<sup>16</sup> stifles the creation of new ideas, dialogue and progress of civil liberties in the state. Secondly, surveillance creates a very steep power dynamic between the watchers (in this case, the government) and those being watched. Any deviant information, no matter how inconsequential, could be used for coercion, discrimination, mala fide prosecution or for the silencing of government-critics. By transcending the public-private divide<sup>17</sup>, surveillance puts the members of the government in a position of greater power, effectively reducing their accountability to the people who elected them in the first place- a sacrilege of democratic principles. The importance of preserving intellectual privacy in a democracy cannot be stressed enough for it is free minds that are the foundation of a free society<sup>18</sup>. Granted, this freedom opens up many routes to deviant behaviour, but restraining the fundamental, democratic liberties of entire the population just for the

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<sup>15</sup> Neil M. Richards, *The Dangers of Surveillance*, 129 AM. J. INT’L L 1934, 1934-1965(2013) [hereinafter Richards].

<sup>16</sup> Neil M. Richards, *Intellectual Privacy*, 87 Texas. L. Rev. 387, 389 (2008) [hereinafter *Intellectual Privacy*].

<sup>17</sup> Richards, *supra* note 15, at 1935.

<sup>18</sup> *Intellectual Privacy*, *supra* note 16, at 388.

reason that some of them may misuse these liberties for anti-social activities is tantamount to throwing the baby out with the bathwater.

A pioneer in the emerging field of Surveillance Studies, Prof. David Lyon has defined surveillance as “the focussed, systematic and routine attention to personal details for purposes of influence, management, protection or direction.”<sup>19</sup> Surveillance is an indispensable tool in the pocket of any modern administrative setup; however, it is also most susceptible to perversion towards anti-democratic ends. The outcomes of surveillance dot every part of the spectrum between “good” and “bad”. It has been used in the war against terrorism, for protection of children from sexual predators and for criminal investigations<sup>20</sup>, however, it has also been misused to detect and censor dissidents<sup>21</sup> by China and to gain access to social media posts in order to quell revolts during the Arab Spring<sup>22</sup>.

Surveillance has not remained confined to the government any more. An ever-increasing number of private corporations are generating small fortunes from studying, collecting and selling detailed online profiles of casual internet users in the name of providing “targeted advertisements”, which are nothing but a more overt form of surveillance<sup>23</sup>. This phenomenon has been identified by Bauman and Lyon as “liquid surveillance- a kind of non-consensual state watching, sometimes-private surveillance in which subjects increasingly consent and participate.”<sup>24</sup> Adding insult to injury, in many nations, the threshold required to be met by investigation agencies, in order to compel private internet service providers to provide personal information of their subscribers, is extremely low. These provisions of

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<sup>19</sup> DAVID LYON, *SURVEILLANCE STUDIES* 23 (1<sup>st</sup> ed., 2007) [hereinafter LYON].

<sup>20</sup> Richards, *supra* note 15, at 1935.

<sup>21</sup> REBECCA MACKINNON, *CONSENT OF THE NETWORKED* 36 (1<sup>st</sup> ed. 2012).

<sup>22</sup> *Id.*; Anupam Chander, *Jasmine Revolution*, 97 *Cornell L. Rev.* 1505, 1516-1517 (2012).

<sup>23</sup> SIVA VAIDYANATHAN, *THE GOOGLIZATION OF EVERYTHING* 26 (1<sup>st</sup> ed. 2011).

<sup>24</sup> ZYGMUNT BAUMAN & DAVID LYON, *LIQUID SURVEILLANCE* 2-3 (1<sup>st</sup> ed. 2013).

law allow for easy access to almost-all transactional information pertaining to a person of interest, including their telephone and email communications, financial records and credit information<sup>25</sup>.

In *Laird v. Tatum*<sup>26</sup>, the U.S. Supreme Court laid down the law that mere apprehension of being under surveillance and therefore feeling deterred from exercising one's First Amendment Right to Freedom of Speech was not actionable in a court of law. In doing so, the court declared that in order for it to safeguard one's right to privacy in communications- there would have to be a substantive injury of the right sought to be protected. While such a ratio would be considered correct in relation to any other right, it is submitted that such is not the case in relation to the right to privacy. A threat to violation of one's privacy of communication is prohibitive of the exercise of said right to such a large extent- that the court might as well have declared that no such right exists in U.S. law. Unsurprisingly, the Sixth Circuit Court went one step ahead in the case of *ACLU v. NSA*<sup>27</sup> where it held that "any suggestion that First Amendment Rights were threatened when the government listened to private constitutions was completely unfounded in reason"<sup>28</sup>. It is clear that the judiciary of the United States has created a very low threshold for intrusion into ones' privacy by agents of the government.

The Indian perspective on a right to privacy remained entirely ambivalent until 2017. In the past, an 8-judge bench of the Supreme Court had held with specific reference to wire-tapping, that "there is no right to privacy enshrined within the Constitution of India."<sup>29</sup> With the

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<sup>25</sup> OFFICE OF THE INSPECTOR GENERAL (U.S. DEP'T OF JUSTICE), A REVIEW OF THE FEDERAL BUREAU OF INVESTIGATION'S USE OF NATIONAL SECURITY LETTERS 10 (2007).

<sup>26</sup> *Laird v Tatum*, 408 US 4-5 (1972).

<sup>27</sup> *ACLU v. NSA*, 493 F.3d 644 (6th Cir. 2007).

<sup>28</sup> Richards, *supra* note 15, at 1943.

<sup>29</sup> *MP Sharma v Union of India*, 1954 AIR 300 (India); *Kharak Singh v Union of India*, 1963 AIR 1295 (India).



discovery of an illegal and expansive network of phone-tapping operations of the government, the Supreme Court expanded the scope of the right to privacy by declaring that such activities could only be justified on the grounds of “public emergency or in the interests of public safety”<sup>30</sup> as provided by the relevant statute- the two grounds being interpreted strictly.

Finally, in 2017, a 9-judge bench of the Supreme Court in the case of *Justice K.S. Puttaswamy (Retd.) & Anr. v. Union of India & Ors.*<sup>31</sup>, overruled the previous position of law and declared that the Right to Privacy is indeed enshrined in Article 21 of the Constitution of India. The court held that any restriction on the Right to Privacy is subject to the test of reasonableness under Article 14 and the limited grounds of Article 19(2) if applicable. Further, any intrusion by the state into the lives of its citizens would have to meet a yet-higher threshold of “compelling state interest”. Finally, the court also devised a four-fold test of “proportionality and legitimacy” as follows:

This state action has to be sanctioned by law;

There must be a legitimate aim of that state action to prevent it from being perverted for ulterior motives;

The action must be proportional to the perceived need for such interference; and

The action should be subject to procedural guarantees to prevent abuse of process.

This hard-line stance in favour of preserving the Right to Privacy was most recently taken by the Bombay High Court where it declared that phone-tapping for the purposes of an investigation into economic offences by an individual neither satisfied the test of the *Puttaswamy*

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<sup>30</sup> PUCL v Union of India, (1997) 1 SCC 301 (India).

<sup>31</sup> Justice K.S. Puttaswamy (Retd.) & Anr. v Union of India & Ors., (2017) 10 SCC 1 (India).

Judgement, nor the twin qualifications of “public emergency” and “public safety” as required by the Telegraph Act, 1887 and was therefore illegal<sup>32</sup>. In a similar vein, The Personal Data Protection Bill, 2019, proposes to set up a personal data protection regime for India by superseding the Information Technology Rules, 2011- which govern the use of personal data of citizens by companies but not by the government. Ordinarily, under the provisions of the Bill, Government agencies would also be held to the same standards as their private counterparts as regards data protection, however- the Bill provides the Central Government with wide discretion to exempt any of its agencies from the provision of the bill in the interest of “security of state, public order, sovereignty and integrity of India and friendly relations with foreign states.” Under this Bill, personal data can also be accessed by government agencies for prevention and investigation of offences, research, to provide benefits to an individual and to respond to medical emergencies. The wide-wording of these provisions opens up many avenues for abuse and risks the creation of an Orwellian state.

With the onset of the COVID-19 pandemic in India, the requirement of contact-tracing of COVID-19 patients became apparent. This requirement was ostensibly fulfilled by the creation of “Aarogya Setu App”. Data collection features of this app came under fire from privacy advocates as soon as the Ministry of Home Affairs made installation of this application on mobile devices of all individuals in all working places mandatory. The privacy policy of this application was updated three times in a short span of time and not one of the three versions gave a clear account as to how personal data of users such as name, age, sex, profession and location, will be used by the government. It was also not clarified why the application needed unrestricted access to the Bluetooth and location settings of the device, why it was collecting data every 15 minutes and why the source code of the application was kept

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<sup>32</sup> Vinit Kumar v Central Bureau of Investigation, 2019 SCC OnLine Bom 3155 (India).

a secret. All these questions have shrouded this application in a web of secrecy and have led to well-founded fears that location tracking features of this application may be used by the government to spy on its own citizens- another Orwellian nightmare.

There is no doubt that the surveillance state is here to stay; it exists as a double-edged sword- on one hand it chills the exercise of our civil liberties, but on the other hand it also helps keep us safe in an increasingly complex and connected world. Some jurists have found a middle way by suggesting that machine processing of data cannot be considered a violation of one's privacy as long as this data is kept from being read by any intelligence officer<sup>33</sup>. The suggestion seems to be that as long as electronic traffic is being sifted through for suspicious material only by the use of autonomous, programmable processes without intervention by any sentient being- one's privacy is preserved. This stance would ostensibly justify the creation of NSA's large data-processing facility in Utah but its effectiveness in being able to assuage the fears of those feeling threatened by this increasingly Panoptic world, is doubtful.

#### IV. ARGUMENTS FOR AND AGAINST PANOPTIC STATE SURVEILLANCE

The Panoptic effect of constant surveillance on citizens by the government cannot be denied. Surveillance cannot be abandoned entirely for the fear that the cyberspace would become the hub of criminal conspiracies- a sort of lawless high-sea at the tips of one's fingers. It is therefore imperative to examine this Panoptic effect in detail before we are capable of drawing a line between what is in the public domain and what isn't.

The fear of being watched forces people to think and act differently than what they would otherwise. An exaggerated, yet significant

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<sup>33</sup>Richard A. Posner, *Our Domestic Intelligence Crisis*, WASHINGTON POST (Dec. 21, 2005) <http://www.washingtonpost.com/wp-dyn/content/article/2005/12/20/AR2005122001053.html>.

iteration of a surveillance state has been created by George Orwell in his book "1984"<sup>34</sup>. Society, in this book has been described as being constricting and the state being totalitarian, personified by the "Big Brother". Citizens of this state are under constant surveillance by "Telescreens" that detect not only verbal dissent against the government, but also the very thought of it. These thoughts are then punished as "thought-crimes". While this depiction is exaggerated, the idea that constant surveillance makes people think and behave differently than they would otherwise, is completely valid. Orwell's novel perfectly depicts Foucault's views on Bentham's Panopticon, the Big Brother being the inspector in a central inspection tower with all citizens in cells all around him, every movement of theirs visible to him, and every thought of theirs known to him.

On a more realistic plane too, many scholars have expressed concerns with regard to the increasing amount of surveillance in our lives. Noted Sociologist, Prof. Anthony Giddens opined that "surveillance continually seeks the supervision of social actors and carries with it the permanent risk that supervision could lead to domination"<sup>35</sup>. Many risks to democratic self-governance<sup>36</sup> too have been exposed, chiefly- self-censorship<sup>37</sup> by citizens fearing prosecution due to deviance from perceived societal norms.

Another pertinent argument against Panoptic surveillance is that the freedoms of speech and expression are so valuable that any state action that has the effect of curbing or limiting them, should err on the side of caution for it is better to allow unlawful speech than to engage in

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<sup>34</sup> GEORGE ORWELL, *NINETEEN EIGHTY-FOUR* (Irving Howe ed, 1<sup>st</sup> ed. 1949).

<sup>35</sup> ANTHONY GIDDENS, *THE NATION-STATE AND VIOLENCE* (1<sup>st</sup> ed. 1985).

<sup>36</sup> Maria Los, *A Trans-Systemic Surveillance: The Legacy of Communist Surveillance in the Digital Age*, in *SURVEILLANCE AND DEMOCRACY* 173, 175 (Kevin D. Haggerty & Minas Samatos eds., 2010).

<sup>37</sup> *Id.*

mistaken censorship<sup>38</sup>. The First Amendment in the U.S and Article 21 in India are both considered the crown jewels of their respective constitutions, as such they have to be protected to a higher degree than what we would for other constitutional features. This view was taken by the U.S. Supreme Court in *New York Times Co. v. Sullivan*<sup>39</sup> where it held that “erroneous statement is inevitable in free debate, ... it must be protected if the freedoms of expression are to have the ‘breathing space’ that they ‘need to survive’.”<sup>40</sup> Noted Professor of Jurisprudence, Timothy Macklem, has expanded this idea by proposing that it is the shield of privacy that allows free exchange of ideas, “that the presence or mere awareness of other people might stifle.”<sup>41</sup> He posits privacy as a “sponsor and guardian to the creative and the subversive.”<sup>42</sup> If he is right, then the regimes of control and surveillance, perpetrated by insecure governments strike at the very heart of intellectual freedom and resultantly, political freedom in a democracy.

It is also important to consider the issue from the point-of-view of governmental agencies. One of the foremost arguments in favour of constant surveillance is that intellectual privacy is a state of mind, i.e. as long as a person does not know that he is under surveillance, he will not change his behaviour and hence there would be no violation of his Freedoms of Speech and Expression. This approach seeks to fulfil the dual purposes of preserving democratic principles as well as safeguarding the interests of the state. However, this logic is not devoid of flaws.

Firstly, no surveillance program of the government is likely to stay hidden indefinitely.<sup>43</sup> In case any evidence is gathered against an

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<sup>38</sup> Richards, *supra* note 15, at 1949.

<sup>39</sup> *New York Times Co. v. Sullivan*, U.S. 254 (1964).

<sup>40</sup> *Id.*

<sup>41</sup> TIMOTHY MACKLEM, *INDEPENDENCE OF MIND* 36 (1<sup>st</sup> ed. 2006).

<sup>42</sup> *Id.*

<sup>43</sup> Richards, *supra* note 15, at 1952.

individual through these programs, they will have to reveal themselves at the time of trial or else said evidence would be rendered inadmissible for fear of abuse of process.

Secondly, the fact the surveillance creates a power-dynamic between the watcher and the watched remains unaddressed by having a hidden surveillance program. Surveillance seldom exists without a purpose<sup>44</sup>- this can encompass anything in the spectrum between counter-espionage on one end, and blackmail of citizens by corrupt officers on the other. If such a system is to remain hidden, then how will the government bring perpetrators of corruption and illegal acts, using information obtained by this surveillance, to justice? The most compelling example of this is the treatment of Martin Luther King, Jr. at the hands of the FBI<sup>45</sup>, where the bureau collected information about his plans and activities through an extensive network of wire-taps and bugged hotel rooms, in order to publicly discredit him. This activity achieved some measure of success as it discovered evidence of his marital infidelity<sup>46</sup>- a deviance entirely disconnected from his socio-political movements, yet a tool in the hands of the security agencies. Whether such discoveries serve the purposes of the observer or not, they do put him in a position of power over the one being observed- opening up many doors for misuse of this information for personal gain of the observer.

## V. CONCLUSION

It has become increasingly difficult to escape the Panoptic eye of modern surveillance systems. There are, undoubtedly, many benefits to this activity- such as disaster management. China's use of its expansive surveillance network has been one of its most potent tools in the war against COVID-19. It has been used to track the GPS locations of those

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<sup>44</sup> LYON, *supra* note 19, at 14.

<sup>45</sup> Richards, *supra* note 15, at 1953.

<sup>46</sup> *Id.*

arriving from abroad and for enforcing lockdowns across the country. Historically, GPS data also allowed the government in tracking the people who an infected person had met before the symptoms become apparent<sup>47</sup>. Such detailed information can also be invaluable in tackling terrorist-organisations, hijacking incidents and hostage negotiations. In a world where knowledge is power- the importance of surveillance for peace-keeping purposes cannot be denied; one may even agree that there is merit in the assertion that privacy is only violated when personal information is made available to a sentient being and not when it's merely filtered and processed by computer algorithms. The other side of the leaf has equal merit. The argument that privacy is a state of mind and the mere fear of being watched over is enough to violate intellectual privacy even if no such surveillance is actually being done.

One thing is clear, democratic principles of free speech and accountability cannot be sacrificed at the altar of Panoptic surveillance. It is then obvious that policymakers must formulate laws that adopt a middle-path whereby the common citizen is reassured about the safety of intellectual privacy while also giving the government tools to extract this information in compelling circumstances.

The first step towards making surveillance more sustainable would be through the establishment of an agency exclusively for this purpose-taking care to make it independent of the Executive and Judiciary. This agency should owe accountability only to a high-level minister specifically tasked with overseeing all surveillance operations. By separating this agency from the Executive, we can ensure that private information of an individual only reaches law enforcement when the latter displays to the former, sufficient cause or a court order. By separating the agency from the Judiciary, we can bring about a change

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<sup>47</sup> Arjun Kharpal, *Use of Surveillance to Fight Coronavirus Raises Concerns About Government Power after Pandemic Ends*, CNBC (Mar. 26, 2020)

<https://www.cnbc.com/2020/03/27/coronavirus-surveillance-used-by-governments-to-fight-pandemic-privacy-concerns.html>.

in the rules of evidence whereby such evidence that is collected through surveillance is subject to stricter judicial scrutiny before being made admissible in a case. In any case, the courts can be directed to issue orders prohibiting such confidential information that has been deemed irrelevant to the case, from being made public by the prosecution.

Procedural laws as well as laws of evidence for prosecutions involving the use of surveillance information would need to be altered so as to ensure that leakage of sensitive information about a person is minimized as against the general public. Strict penal provisions for the misuse of such information by public servants to further their own ends would also go a long way in assuaging the fears that people have for their intellectual freedoms. While judicial warrants are still required for access to personal data in many countries in the same way that a warrant is required in order to search private premises, the threshold to be met in order to gain access to someone's digital identity has to be much greater than the standard which is ordinarily applied in the aforementioned case.

In the past few years, many countries have moved their citizen databases online, one of the more recent as well as widely-criticized being the AADHAAR scheme by the Government of India. AADHAAR is the world's largest biometric identification system that was conceived as a framework that Indians could voluntarily enter into, in order to avail a wide array of benefits from the government of India, by subscribing to a 12-digit identification number based on biometric and demographic data. The voluntariness of this scheme has been substantially diluted in the past few years given its mandatory linkage with many essential services such as SIM cards, bank accounts, EPF accounts, old-age pensions, central government employment schemes



etc<sup>48</sup>. This scheme, like many similar ones in other countries, has attracted criticism for the fear that it is the first step in the creation of an all-assuming, panoptic surveillance system in India. If this were to become an unregulated and uncontrolled reality, the enjoyment of civil liberties in this country would become a thing of the past. While it is conceded that the evolution of one such system is inevitable in any modern society, it has to be done with utmost care by always leaning in favour of laws that give civil liberties a wide berth as compared to restrictions caused by surveillance. The Supreme Court too, *via* a majority judgement, has opined that while the fears that such a scheme might be used for data profiling of citizens, the larger public interest served by the existence of such a system meets the test of proportionality and therefore does not fall foul of Constitutional principles<sup>49</sup>. In his dissenting opinion<sup>50</sup>, Chandrachud, J. has held that in order to protect against arbitrary and abusive use of personal information, the state has to provide a framework of data protection laws that ensure that such data is collected and used only in line with the terms to which the citizen has consented and not otherwise- since the AADHAAR framework does not satisfy this need, he deems it unconstitutional.

The world has undoubtedly assumed a Panoptic structure with governments in the central watchtower and their citizens in surrounding cells. The cyberspace has become an institution that uses the fear of being spied upon as a behaviour control mechanism that has its positive as well as negative aspects. We must evolve structures that allow for the maximum enjoyment of civil liberties while also allowing those who protect us- the use of these technologies. This will only be achieved by the establishment of a surveillance system that is accountable to the people it serves- its citizens. For now, we must make

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<sup>48</sup> K. Deepalakshmi, *The Long list of Aadhaar-linked schemes*, THE HINDU (Mar. 24, 2017) <https://www.thehindu.com/news/national/the-long-list-of-aadhaar-linked-schemes/article17641068.ece>.

<sup>49</sup> K.S. Puttaswamy (Aadhaar-5J) v Union of India, (2019) 1 SCC 1 (India).

<sup>50</sup> *Id.*

the choice between foregoing our intellectual privacies for the benefits of state surveillance and preserving these invaluable rights at the cost of decreased state protection.

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## MIGRANT CRISIS IN INDIA: A PANDEMONIUM OVER A PANDEMIC

- Aishwarya Vardhan and Sanjana Sharma\*

### ABSTRACT

*The all-pervasive COVID-19 virus has engulfed the world in an aura of apprehension and dismay, and additionally, it has brought into being certain pitiful circumstances resulting in untoward events which are not only causing extreme hardship to many but are also proving to be difficult to contain. The Migrant Crisis in India is one such colossal event that has taken place owing to the nationwide disorganisation. While the pandemic has left the hoi polloi stupefied, the worst affected are the migrant labourers who did not get a proper caveat before the sudden imposition of complete lockdown. The miserable plight of these workers not only rendered them incapable of preventing themselves from contracting the virus but also leaves a scar on their mental and physical well-being during these testing times.*

*This research paper casts a light upon the various facets of the plight of the migrant workers and in this context, provides a constructive critique of the policies and management of the government. The authors in pursuance of the same have focused primarily on the psychological and legal dimensions of the issue along with a few proposed suggestions.*

**Keywords:** *migrant workers, COVID-19, transportation, government, mismanagement*

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## I. AN INTRODUCTION TO THE ROARING MIGRANT CRISIS

Migration, a process of moving from one place to another, is not a novel concept. Although much deliberated in the present time, this odyssey dates back to a million years. The homo erectus is said to have migrated across Africa during the Pleistocene Epoch.<sup>1</sup> The reason for migration back then was mostly concerned with safety, security and search for a favourable climate and utilities. Their manoeuvres were driven by exploration of fertile land and their forage for animals to satisfy their appetite. On the other hand, present-day migrations have other factors behind them, *vis-à-vis* better job opportunities and improved lifestyle. The most potent reason for migration is remuneration.<sup>2</sup> Not only people from lopsided regions but also those who are well-settled would be willing to migrate in order to secure a better paying job opportunity. Humans are always striving for the better, in fact, Sigmund Freud in his celebrated work 'Civilisations and its Discontents' talks about the impossibility of satisfaction in a man.<sup>3</sup> Hence, migration is a natural process, the catalysts of which are several factors.

However, the common ground of migrations over the ages has been convenience. This convenience may be in any form, financial, social or personal. And this has stirred several controversies and discussions in the world. Even so, one person's convenience is not necessarily another person's nuisance. Migrants don't only secure their own interests but also end up contributing to the economic and social life of the host country or area. They are neither a burden nor a panacea. They participate in the workforce of the region and have

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<sup>1</sup> VIII, RUSSELL H. TUTTLE, PALEOANTHROPOLOGY: MORPHOLOGY AND PALEOECOLOGY 353, (MOUTON PUBLISHERS 2011).

<sup>2</sup> ALICE BLOCH, NANDO SIGONA, AND ROGER ZETTER, NO RIGHT TO DREAM, (Paul Hamlyn Foundation 2009) <https://www.phf.org.uk/reader/right-dream/chapter-2-migration-youth-motives-expectations-circumstances>.

<sup>3</sup> 8 SIGMUND FREUD, CIVILISATION AND ITS DISCONTENTS, (Chrysona Associates Limited 1929).

to subscribe to its law and order.<sup>4</sup> They do not in any way stand in the development of the place and still bear the brunt of being called an illegal outsider. From the European Union migration upheaval to our own domestic migration crises in not just one but several states, it is the migrants who end up being harassed and persecuted.

In India particularly, the outbreak of COVID-19 has brought into light the humongous economic divide, the best and worst facade of humanity, and very importantly, the massive incompetence of the government to deal with the pandemic and to serve the interests of the citizens equitably.

Migration, if not well-planned and managed, leads to the destruction of life and wealth. It is worth mentioning that prior to this incident; there have been two-other extremities concerning migrants in India's history. During Tughlaq's reign, the country witnessed one of the worst cases of mass migration.<sup>5</sup> The unnecessarily forced migration of people from Delhi to Deogiri, without a proper arrangement, had a debilitating effect on the people, many of whom lost their lives in the process.

The second monumental migrant crisis took place in 1947. The independence of the country was surely a harbinger of pride and jubilation; however, it also paved the way for huge mayhem due to the partition. It led to people fleeing their homes in order to flee danger and crossing borders in adverse situations. The mass exodus and influx caused a nation-wide bedlam where again, it were the vulnerable who were the most affected.

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<sup>4</sup>Migration Policy Debates, Is Migration Good for the Economy, OECD, May 2014, <https://www.oecd.org/migration/OECD%20Migration%20Policy%20Debates%20Numero%202.pdf>.

<sup>5</sup> VINCENT A. SMITH, THE OXFORD HISTORY OF INDIA: FROM THE EARLIEST TIMES TO THE END OF 1911, 217 (Oxford, Clarendon Press, 1919).

History should have inculcated in us the significance of being respectful and accommodating to the helpless. Or rather, we should have learnt our due lesson from these noteworthy incidents. But alas, we needed one more wake-up call in the form of the current migrant crisis, the end of which still seems unclear.

## II. AN ACCOUNT OF THE WOEFUL LIVES AMIDST THE PANDEMIC

While people are advised to stay at home to avoid contacting the fatal virus, a myriad of hapless migrant labourers had no other option but to start their journey on foot to their home. Some did reach their destinations, however, others, unfortunately could not. The most upsetting part of this was the underwhelming response of the government. When the country was playing a utensil orchestra and a symphony of applause, the migrant workers were dancing to the tunes of uncertainty.

As a matter of fact, the media has seemed to do more than the government to help the needy out of this dire situation. A number of disheartening pictures surfaced in the newspapers and on social media, clearly depicting the misery these workers were subject to.<sup>6</sup> This helped in bringing tremendous attention to their predicament.

Some workers started their journey of a thousand miles on foot, while others hid themselves in cement trolleys to escape the wrath of the police and reach their destination.<sup>7</sup> The gravity of this situation could have been much less, had the lockdown been imposed with an adequate warning and had the poor and needy received a helping

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<sup>6</sup> Shubhabrata Roy, *Migrant Voices-Stories of India's Internal Migrant Workers During the COVID-19 Pandemic*, INSTITUTE FOR HUMAN RIGHTS AND BUSINESS, Nov 24, 2020, <https://www.ihrb.org/focus-areas/migrant-workers/india-internal-migrant-workers-covid-19>.

<sup>7</sup> Rajesh Roy and Vibhuti Agarwal, *Millions of Indians are Fleeing Cities, Raising Fears of a Coronavirus 'Land Mine' in Villages*, THE WALL STREET JOURNAL, May 27, 2020, <https://www.wsj.com/articles/indias-migrants-head-home-as-lockdown-eases-prompting-fears-of-coronavirus-spread-11590579072>.

hand from the government. This was a situation that demanded government aid the most. It is almost ironic how all of our statutes are written 'in the interest of public' and yet the interest of the public is the most compromised. In fact, the '*Sankalp Patra*', or the manifesto of the incumbent government consisted of, *inter alia*, the comprehensive social security coverage for all unorganised labourers, however, these lofty plans did not materialise.<sup>8</sup> Be that as it may, the saving grace of the needy were some businessmen, Bollywood celebrities and in one incident, even a thirteen-year-old who gave away her savings to help the migrant workers.<sup>9</sup>

These workers were not even given adequate medical facilities, let alone social security by the government in this challenging time.<sup>10</sup> On the contrary, there have been disgraceful incidents of them being beaten and tortured by the police. Brutality on top of this rampant pandemic won't only result in physical scars and bruises but they might also leave a permanent dent on the psyche of these individuals. Most of them have not only lost their respective jobs but also most of their savings, which they had to use for their conveyance back to home.

The PM Cares Fund receives thousands of crores of donations in a week, which no doubt have been efficiently used in building COVID care centres and making provisions for more beds for the patients. However, it has failed to help out the migrant workers. To make the situation worse, money was in fact charged from them to

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<sup>8</sup> Bharatiya Janata Party, *Sankalp Patra, Inclusive Development* 43, Lok Sabha (2019).

<sup>9</sup> Geeta Pandey, *India Coronavirus: Bollywood Actor Sonu Sood Hailed for Helping Migrants*, BBC NEWS, May 25, 2020, <https://www.bbc.com/news/world-asia-india-52783084>.

<sup>10</sup> Sanjay Kumar, *What Government Agencies Can Do to Ensure Safety and Security of Migrant Workers*, THE TIMES OF INDIA, May 16, 2020, <https://timesofindia.indiatimes.com/blogs/toi-edit-page/what-government-agencies-can-do-to-ensure-safety-and-security-of-migrant-workers/>.

buy the tickets of Shramik Express, which in some instances got refunded, and in many others, just added to their financial burden. Not only did they have to pay for their transportation after their displacement, but they also had to go through a rigorous registration process in order to make themselves eligible to travel back. The need to simplify the strenuous registration process has been expressed by the Supreme Court<sup>11</sup>, Bombay High Court<sup>12</sup> and Telangana High Court.<sup>13</sup> Furthermore, the Supreme Court also directed the Government to clearly announce and broadcast the places where registrations would take place, so that that the time and resources of the already burdened workers are saved.<sup>14</sup>

Towering claims were made by both the Central and State government, however, the fact remains that they were for the most part hollow. Their sombre saga doesn't end here. The labourers were not provided with food or even water in their journey. Unfortunately, about eighty people are said to have lost their lives and many others travelled in dire conditions.<sup>15</sup>

Moreover, the migrant labourers became an involuntary carrier of the virus. A virus that is mostly limited to urban areas elsewhere in the world has travelled to even the remote rural areas in India. These workers had no other option but to gather and travel back together, breaking the norm of social distancing. They couldn't have survived in the big cities without work and shelter.

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<sup>11</sup> *In Re: Problems and Miseries of Migrant Labourers*, (2020) SCC OnLine SC 492.

<sup>12</sup> *Center of Indian Trade Union and Ors. v. State of Maharashtra and Ors.*, (2020) SCC OnLine Bom 679.

<sup>13</sup> *S. Jeevan Kumar v. State of Telangana*, (2020) SCC OnLine TS 529.

<sup>14</sup> *id.* At 8.

<sup>15</sup> FPJ Web Desk, *At Least 80 Migrants Have Died on Shramik Trains*, THE FREE PRESS JOURNAL, May 30, 2020, <https://www.freepressjournal.in/india/at-least-80-migrants-have-died-on-shramik-trains-from-may-9-to-may-27-over-52-lakh-passengers-transported-says-railways>.



By the same token, even the Indian migrant labourers working abroad, more specifically, in the Gulf countries found themselves in the same circumstance. As per a report by the International Labour Organisation, around nine million low and semi-skilled Indian workers work in the Middle East.<sup>16</sup> On top of their existing difficulties concerned with wages, accommodation and irregular work, they are now perturbed by the pandemic. In this situation too, the government of India couldn't rescue the stranded workers. The Vande Bharat Mission, which was initiated to bring back the Indians from other countries did not even operate *pro bono* to help the poor migrant workers, let alone provide them subsidised tickets.

Clearly, the repercussions of misadventures of the Indian government are tugging at the heartstrings of the migrant workers.

### III. THE REQUIREMENT OF PSYCHOLOGICAL FIRST-AID

In the current global pandemic, the milieu is deplorable to say the least. There are all kinds of discussions about the social, economic and political aspects that the informal sector is grappling with. The world at large is spending a considerable amount of time educating everyone around them about the precautions one must take, the significance of sanitation, the safety measures to be undertaken and how to keep oneself medically fit. However, the authors feel that the people and the country at large is not stressing enough on the psychological aspects and how the pandemic is affecting people's psyche worldwide particularly the migrants, displaced persons and other vulnerable groups.

In the words of the celebrated author CW Lewis, *"Mental health is less dramatic than physical pain, but it is more common and harder to bear."*

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<sup>16</sup>India Labour Migration Update (2018), INTERNATIONAL LABOUR ORGANISATION, [https://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/---sro-new\\_delhi/documents/publication/wcms\\_631532.pdf](https://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/---sro-new_delhi/documents/publication/wcms_631532.pdf).

*The frequent attempt to conceal mental pain increases the burden: it is easier to say 'my tooth is aching' than to say 'my heart is broken'".<sup>17</sup>*

Mental Health although one of the most fundamental aspects of an individual's social, emotional and psychological well-being, has been disregarded since ages. When one talks about mental health, there is a range of psychological problems one needs to focus upon *vis-à-vis* anxiety, panic attacks, depression, post-traumatic stress disorder ("PTSD"), somatic symptoms and suicidal tendencies. These illnesses are more likely to be prevalent in the neglected workforce during COVID-19. Social distancing is a utopian impossibility and renders them incapable of abiding by the COVID-19 rules of isolation, quarantine and personal hygiene.

Every epidemic in global history has a visible physical aftermath, however, this aftermath is not just limited to the physicality but goes way beyond that. Rampant outbreaks like these have myriad impacts on the mental health of society at large. This impact is caused due to the fear that emanates from being left alone, of not being able to sustain oneself and family financially, negligible moral support from families, poor access to health care, pre-existing psychological morbidities and social ostracizing. Then comes the heavy economic load of financial constraints and joblessness, which makes the marginalized group susceptible to negative cognitive responses. The ill-effects of such an epidemic are graver in a tech-savvy generation where the access to information is readily available. The absence of reliable guidance, genuine information and adequate supplies has been the major source of stress among the masses. It influences their already sinking mental health which inadvertently hampers the productivity of the migrant workers. Hence, it is imperative that the epidemic response includes broad

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<sup>17</sup> C.S. LEWIS, THE PROBLEM OF PAIN 102 (Samizdat University Press, Quebec 2016).

plans for addressing mental health and removing the stigma surrounding it, if any.

Men, women and children starting arduous journeys across states travelling thousands of kilometers without food, drinking water and even sleeping on pavements, hiding themselves in milk vans, water tankers, surviving on salt are a few instances that simply depict the vexation caused to the migrants and showcase the shoddy plans of the government. The harrowing circumstances of these migrants need to be addressed. Instances like these are bound to negatively affect the psyche of the sufferers which may lead to Post Traumatic Stress Disorder which in turn, might get exacerbated in the years to come.

Many of the migrant labourers after having completed an extremely tedious and vexing journey back to their respective homes are refusing to come back to the metropolitan cities and urban areas. This must have been an extremely tough decision considering the fact that their livelihood depends on their jobs. Their reservations with respect to returning are largely owed to their fear of being subjected to this affliction once again and to their rightful resentment towards the government and their respective employers.<sup>18</sup>

A reference to the Behaviorist Theory propounded by B.F. Skinner becomes relevant here.<sup>19</sup> This theory essentially states that a person's action is attributed to what is going on inside him. Hence, the refusal of the migrant workers to return to the big cities to earn their livelihood and their choice to rather live on salt and bread than to secure themselves and their families a better life says a lot about

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<sup>18</sup> Roli Srivastava, *"I Will Never Come Back": Many Indian Migrant Workers Refuse to Return to Cities Post Lockdown*, SCROLL.IN, May 30, 2020, <https://scroll.in/article/963251/i-will-never-come-back-many-indian-migrant-workers-refuse-to-return-to-cities-post-lockdown>.

<sup>19</sup> B.F. SKINNER, *THE BEHAVIOUR OF ORGANISMS, AN EXPERIMENTAL ANALYSIS* (Richard M. Elliot ed., Appleton Century Publishers, 1938).

their inner angst. Inside them is a lot of anxiety, stress and trauma, so much that the already economically downtrodden is not giving a priority to earning money and living a better life, because the latter doesn't seem to be guaranteed or even plausible in the present circumstances.

Thankfully, the panic and agony has been acknowledged by the Supreme Court in the case of *Alakh Alok Srivastava v. Union of India* where the court emphasised on the necessity to provide the distraught migrant workers with the necessary psychological first-aid.<sup>20</sup>

Chapter VI of the Mental Healthcare Act, 2017 lays down the duties of the appropriate Government to improve the condition of mental health among the citizens.<sup>21</sup> The World Health Organization estimates that the burden of mental health problems in India is unprecedented and the Indian population forms a substantial part of the global mental health crisis.<sup>22</sup> Hence, these provisions, if properly adhered to, can still contribute in making a positive change in the overall health of the country.

Therefore, contrary to other developed countries, India is not only combating a widespread pandemic but also a migrant labour crisis. Within the labour crisis, there exists a crisis that has to be combated emotionally.

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<sup>20</sup> *Alakh Alok Srivastava v. Union of India*, (2020) SCC OnLine SC 352.

<sup>21</sup> The Mental Healthcare Act, Ch. VI, § 29-32 (2017).

<sup>22</sup> *Mental Health in India*, Health Topics, WORLD HEALTH ORGANIZATION, [http://origin.searo.who.int/india/topics/mental\\_health/about\\_mentalhealth/en/#:~:text=Mental%20health%20in%20India%3A,per%20100%2C000%20population%20is%2021.1](http://origin.searo.who.int/india/topics/mental_health/about_mentalhealth/en/#:~:text=Mental%20health%20in%20India%3A,per%20100%2C000%20population%20is%2021.1).

#### IV. PROTECTION OF MIGRANT WORK FORCE – THE BLIND SPOT IN OUR LEGAL SYSTEM

India is a country with the longest written constitution, a large number of statutes and the largest democracy in the world. Having several accolades to its name, it is a matter of disgrace that it isn't being able to secure the interests of the disadvantaged section of the society when they need it the most.

While it is true that the government has lent a helping hand in providing food and basic amenities to these workers, it has been reported by the Stranded Workers Action Network that the rate of hunger and distress exceeded the rate of relief.<sup>23</sup>

The country is currently caught up in continuous chaos where among other things, the legal rights of these migrant workers are also placed on the scaffold. Some of the statutes, even after being enacted in the country years ago, haven't been implemented to date, hence being nothing more than a book of fiction. Deliberations have been happening on the implementation of the Inter-State Migrant Workmen (Regulation of Employment and Conditions of Service) Act, 1979 for over three decades. This Act has specifically come into existence to protect the interests of workers working outside their native states. Sections 14 and 15 of the Act clearly state that the workers are entitled to a displacement allowance and home journey allowance respectively.<sup>24</sup>

The Supreme Court had observed in the case of *Labourers Working on Salal Hydro Project v. State of Jammu & Kashmir* that the provisions of this act weren't implemented and accordingly directed

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<sup>23</sup> 21 Days and Counting, *Covid-19 Lockdown, Migrant Worker and the Inadequacy of Welfare Measures in India*, STRANDED WORKERS ACTION NETWORK, [https://www.thehindu.com/news/resources/article31442220.ece/binary/Lockdown-and-Distress\\_Report-by-Stranded-Workers-Action-Network.pdf](https://www.thehindu.com/news/resources/article31442220.ece/binary/Lockdown-and-Distress_Report-by-Stranded-Workers-Action-Network.pdf)

<sup>24</sup> Inter-State Migrant Workmen (Regulation of Employment and Conditions of Service) Act, § 14 and 15 (1979).

the government to implement it.<sup>25</sup> This was a PIL filed by the aggrieved workmen working on the Hydro Electric Project, who were wrongfully denied the benefit of certain provisions of labour laws. However, even after the conspicuous observations of the Court to make them applicable, it still wasn't complied with. Years down the line, this question arose again in the case of *Public Union for Civil Liberties v. State of Tamil Nadu*, where the directions for the implementation of this Act were issued yet again.<sup>26</sup> And finally, the present scenario of the country called for another look at the need for the implementation of this Act. In the recent case of *Sashank S. Mangal and Anr. v. Govt. Of NCT of Delhi and Ors*, the Delhi High Court in view of the above observations stated that in order to implement the Act, a proper data and a status report have to be filed initially and then the court will give the appropriate directions.<sup>27</sup> It is hoped that at least, this time the implementation of this Act is not stalled as we cannot wait for another unprecedented adversity to further open our eyes.

Very importantly, the migrant workers are entitled to their constitutional rights. In the light of the existing circumstances, the Allahabad High Court in the case of *Shaad Anwar v. State of U.P.* has observed that a court, being a guardian of the Constitution, has the duty to interfere when there is an abuse of power or violation of a right.<sup>28</sup> The situation of the migrant workers currently calls for the constitutional protection since they are being deprived of their equal protection of law, and right to move freely throughout the country

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<sup>25</sup> *Salal Hydro Project v. State of Jammu & Kashmir*, (1983) 2 SCC 181.

<sup>26</sup> *Public Union for Civil Liberties v. State of Tamil Nadu*, (2013) 1 SCC (L&S) 215.

<sup>27</sup> *Sashank S. Mangal and Anr. V. Government of NCT of Delhi and Ors.*, 2020 SCC OnLine Del 621.

<sup>28</sup> *Shaad Anwar v. State of U.P.*, 2020 SCC Online All 683.

and the right to protection of life and personal liberty, enshrined in Articles 14, 19(1)(d) and 21, respectively.<sup>29</sup>

India is a welfare state which shall strive to ensure socio-economic justice.<sup>30</sup> The very essence of the constitution is to provide equal protection to all its citizens. Part IV of the Constitution incorporates the Directive Principles of State Policy. These rights, although do not create a justiciable right, are enforceable in the courts of law.<sup>31</sup> Article 43 specifically lays down provision regarding the living circumstances and wages of workers, agricultural, industrial or otherwise. However, unfortunately, even the basic amenities are not being granted to them, let alone decent living conditions and fair wages.

A group of senior and reputed advocates including legal luminaries like Indira Jaising and Kapil Sibal in a letter addressed to the Supreme Court have expressed their dismay on the current state of events.<sup>32</sup> The said letter critically evaluates the efforts of the government and emphasises the need to pull out all the stops in improving the ordeal of the migrant workers. The Central government, on the other hand, has sought a direction from the Supreme Court to prevent the media from telecasting anything non-factual. It wants the media to confirm the veracity of any incident from the Central Government itself and run the news through it first. The government believes that fake news is being circulated to show a worse picture of the state of affairs of the country. We have stooped

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<sup>29</sup> INDIA CONST. Art 14, 19(1)(d) and 21.

<sup>30</sup> Union of India v. Hindustan Development Corporation, AIR 1994 SC 988.

<sup>31</sup> DURGA DAS BASU, SHORTER CONSTITUTION OF INDIA 443 (13<sup>th</sup> Ed., Wadhwa Book Company, 2003).

<sup>32</sup> Krishnadas Rajagopal, *Hours Before Taking up Migrant Workers Issue, Supreme Court got Stinging Letter from Senior Lawyers*, THE HINDU, May 27, 2020, <https://www.thehindu.com/news/national/hours-before-taking-up-migrant-workers-issue-supreme-court-got-stinging-letter-from-senior-lawyers/article31685187.ece>.

to the point where the media is blaming the government and vice versa, and little to no actual benefit is accruing to the needy.

On the brighter side, among the ambiguities and the blame-game, the National Human Rights Commission has filed an application in the Supreme Court in the wake of the present pandemonium.<sup>33</sup> It has proposed certain essential measures to ease the hardships being faced by the migrant workers.

Moreover, it is pertinent to note here that the government had decided to introduce a comprehensive four-code labour statute encompassing forty-four labour laws in the country, with certain modifications and amendments.<sup>34</sup> It includes laws relating to both organised and unorganised sectors and in fact, due importance has been given to the latter in the same. While it brings about essential changes with respect to diversity and representation of workers as well as maternity benefits programme, there have been few mentions of improvement in the work conditions and wages of migrants.

It has been reasonably clear from the abovementioned instances and examples that the welfare of the migrant workers has taken a subservient position in relation to the apparent 'much bigger' goals of the country, economy and of course, the organised sector.

## V. COMPARATIVE ANALYSIS OF INDIA ON A GLOBAL PLATFORM

India is one of the top-most affected countries owing to the outbreak of the virus, following the United States, Brazil and

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<sup>33</sup> *Supreme Court Allows NHRC Intervention in its Suo Motu Writ Petition on the Problems and Miseries of Migrant Labourers in the Wake of Nationwide Lockdown*, National Human Rights Commission, India, (June 05, 2020).

<sup>34</sup> *Labour Law Reforms*, Labour Reforms Initiative, Ministry of Labour and Employment, Government of India, <https://labour.gov.in/labour-law-reforms>.



Russia.<sup>35</sup> Being the most populated<sup>36</sup> out of the lot and having over 139 million internal migrants,<sup>37</sup> the battle of India is in reality, incomparable.

However, both Brazil and India being developing countries and the former also consisting of a section of migrant workforce in the country and outside as well, a parallel can be drawn in their current stature. The head of the Migration Association of Brazil, Cyntia de Paula, has received innumerable requests from Brazilians caught up in this incessant commotion.<sup>38</sup> While the migrants have been transferred to care shelters, some of them continue to struggle in the crowded camps with absolutely no social distancing norms; others have been receiving a better facility with a regular food provision.<sup>39</sup> Hence, although the situation is not as adverse as it is in India, it is no good either. Owing to the huge disparity in the population of both the countries, it is safe to say that this migrant crisis, like several other prominent issues plaguing the country, comes down to the larger issue of an incredibly large population.

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<sup>35</sup> COVID-19 Dashboard by the Center for Systems Science and Engineering at John Hopkins University, Corona Virus Resource Center, John Hopkins University, <https://coronavirus.jhu.edu/map.html>.

<sup>36</sup> Total Population Data, The World Bank, <https://data.worldbank.org/indicator/SP.POP.TOTL>.

<sup>37</sup> The World Economic Forum COVID-19 Action Platform, *India has 139 Million Internal Migrants, They Must Not be Forgotten*, WORLD ECONOMIC FORUM, (Oct 01, 2017), <https://www.weforum.org/agenda/2017/10/india-has-139-million-internal-migrants-we-must-not-forget-them/>.

<sup>38</sup> Reuters, *Coronavirus Crisis Heaps Hardship on Brazilian Migrants in Portugal*, US NEWS WORLD REPORT, April, 24, 2020, <https://www.usnews.com/news/world/articles/2020-04-24/coronavirus-crisis-heaps-hardship-on-brazilian-migrants-in-portugal>.

<sup>39</sup> Victoria Huguency, *Coronavirus Threatens Indigenous Venezuelans Seeking Safety in Brazil*, UNHCR, (May 19, 2020), <https://www.unhcr.org/news/stories/2020/5/5ec2f2b94/coronavirus-threatens-indigenous-venezuelans-seeking-safety-brazil.html>.

Moreover, India, being a part of several supranational organizations and having signed various treaties for the welfare of the country and its citizens, has an added responsibility to fulfil its obligations.

The International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families is a comprehensive mechanism that seeks to administer and safeguard the rights and privileges of migrant workers and their families worldwide.<sup>40</sup> One of the principal focus of the United Nations treaty is to set minimum standards for migrant workers and members of their families, with an emphasis on eliminating the exploitation of workers in the migration process. The global agreement sets a moral standard thereby serving as a guide and championing the rights of migrants. Around 55 states have ratified the Convention while India has not even signed it. In a country like India where the state of affairs depends colossally on the migrants, the protection of their rights ought to be of paramount importance. It is rather insensitive that the unorganized sector is conveniently ignored and their rights are suppressed while there are all endeavours to foster the development of the organized sector.

India being a member of the International Labour Organisation, which inter alia advocates the significance of core rights for the working class in the world economy, has failed to secure them their prerogatives. Moreover, despite India having signed the Universal Declaration of Human Rights, the document which has proven to be monumental in influencing the country's constitution, we are witnessing how egregiously India is failing at keeping up with these conventions and securing minimum rights for its building blocks—the migrants.

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<sup>40</sup> International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families (1990).

It is hoped that the future of the country witnesses active participation and deliberations to ameliorate the conditions of migrant workers and eradicate the practice of systematic abuse and exploitation of these workers, who are instrumental in bolstering the economy to a large extent.

#### VI. WHAT COULD INDIA HAVE DONE DIFFERENTLY?

A lockdown without any planning for India's millions of teeming migrant workers and daily wage earners has led to a deep humanitarian emergency. A crisis that encompasses immense dimensions and that one can safely proclaim that the never-ending plight of migrant workers and the informal sector has taken the forefront dwarfing the pandemic in India.

It is an indisputable fact that India has and is continuing to pay a huge price for the poorly planned lockdown imposed impulsively. Colossal mismanagement in the movement of migrant labourers across India has not only jeopardized the lives of millions of migrants but also precipitated the largest ever humanitarian crisis, rendering the pandemic to the back-burner. It is not a herculean task to understand that the government has carried out a half-brained operation. The initial period of the lockdown could have been constructively utilized in informing people about the lockdown to be imposed. In a country like India, where the class divide is gargantuan one cannot disregard the informal sector.

Before announcing the biggest lockdown in the world overnight, the scenario could have been thought through. It is of paramount importance that the government undertakes a nuanced approach and takes into account the complex realities of the variegated sections of people existing in the Indian society. The inefficient administration and the constant tussle between the state and the union has caused mayhem across the country and trampled upon the hopes of the unorganized sector.

Under the Constitution of India, labour is a subject where both the Central and State governments are empowered to make laws subject to some issues reserved for the Centre. Concurrent List, being the third list contains inter alia, matters of common interest to both the Central Government and the State Government. Since labour is an issue that comes under the Concurrent List, there should have been appropriate measures undertaken by the government to ameliorate the miseries of the migrant workers. Entry number 22 of the Concurrent List of powers mentions “trade unions, industrial and labour dispute”, while entry number 24 contains the provision regarding the welfare of labour including conditions of work, employer’s liability and related concerns.<sup>41</sup> Hence, if both the Central and State governments work in tandem, a great deal of our goals can be achieved.

While the Constitution has readily made provisions to empower the Parliament with the above-mentioned powers, the incumbent government has failed the Indian population outrightly, in particular, the informal sector by not using effectively the powers listed in the Seventh Schedule. The insensitiveness and incompetence of the government with respect to this matter is making this humanitarian crisis even worse.

*Another question that arises is: Why did Shramik Express, the train earmarked for transporting migrants to their home from where they were stranded, start so late and more so when it was riskier for travel to take place, since cases had increased?*

A month after announcing the nationwide lockdown when the mass exodus had outstretched to a different level, was when the government woke up to the predicament of the vulnerable groups. It was only two days after the buses were allowed to operate, that the Central Government permitted the Indian Railways to launch

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<sup>41</sup> INDIA CONST. Entry 22 & 24, 7<sup>th</sup> Schedule.

Shramik Express.<sup>42</sup> Rather, it would have been more prudent on the part of the government to give the migrant workers an opportunity to return to their homeland before serving the eleventh-hour notice. The lockdown could have been better implemented after stabilising the exodus.

While the entire country and the world at large was witnessing an exponential surge in the total count of COVID-19 cases, the Indian state of Kerala successfully decreased the mortality levels to the lowest in the country. A state which was one of the worst affected in the beginning changed the scenario dramatically and emerged as a model that each state in the country yearned to emulate in battling the contagion. The credit for this remarkable achievement can be given to the swift action of the government, priority to the public health sector and migrant-friendly atmosphere.

Predominantly, the state started early preparations and commenced testing and screening on an enormous scale. There was aggressive testing throughout the state and the active cases were quarantined without delay. To tackle the ravaging pandemic, there was a thorough contact tracing and a meticulous attempt at identifying people who might be a potential carrier. Large scale community participation involving panchayats and volunteers proved to be a great aid. In addition to this, people under home quarantine, particularly the migrants, also called “guest workers” were provided with free food, medical care, essential supplies and even mental health care. Help desks were set up to allay their concerns. Pro-active steps right from exceptionally testing the home quarantined people, following up on them to detect secondary cases and ensuring wage benefits for the migrants was the unique selling

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<sup>42</sup> Press Information Bureau, *Updates on Covid-19 the Ministry of Health and Welfare*, The Daily COVID Bulletin, May 26, 2020, <https://pib.gov.in/PressReleasePage.aspx?PRID=1626956>.

proposition of the Kerala Model put forward by their Minister of Health and Social Welfare, Smt. KK Shailaja.

While the top centre leaders were busy communalizing the pandemic, Kerala battled the devastating disease by good governance with humanitarian values coupled with efficient health care and administration system.

## VII. CONCLUDING COMMENTS

Before imposing the lockdown overnight, a great deal of anticipatory analysis was called for. The government failed miserably at apprehending the detrimental effects the lockdown would have on the informal sector. It is still unclear whether the government could not foresee or did not wish to foresee the deleterious consequences of an inadequately thought of and poorly imposed lockdown, considering the social stratification of a country like India. It is disheartening to think that the government did not mull over the prodigious class divide of the Indian society and treated the populace like cult toys performing to its whimsical commands of clanging pots and lighting the lamps.

While some degree of crisis is inevitable in India owing to the enormously large population, the Supreme Court's endeavor in safeguarding the fundamental rights of the migrant workers is laudable. The Apex Court was vigilant of the Executive's actions and took *suo moto* cognizance over the migrant crisis in the wake of the pandemic. Elaborate procedures and concentrated efforts undertaken by the highest court of record to cover up for the lapses on the part of the Centre and the states helped in mitigating the miseries of the migrants to a great extent.

In addition to this, the government ought to address the challenge wholeheartedly by recognizing the needs of the unorganized sector, putting things into perspective and including

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them in healthcare services, providing cash transfers and allied socio-economic programmes. The country's current mental health situation calls for active policies, significant resource allocation and a great political will. Having strong mental health is of utmost importance since its deterioration will only prove to be an impediment to the ability of the nation to battle the disease.

To conclude, India should be well equipped to deal with any such crisis that may arise in the future by having a comprehensive and nuanced approach as well as actively including the migrants and the unorganised sector in its policies.

## CREDIT DEFAULT SWAPS AND INSURANCE: THE PERPETUAL CHARACTERIZATION CONUNDRUM

- Divij Jain\*

### ABSTRACT

*A Credit Default Swap (“CDS”) is a credit-risk hedging tool, popular amongst banks, hedge funds, insurance companies and other such financial institutions, with a cumulative commercial value larger than entire economies. However, these instruments remain in muddy waters due to the lack of any legally binding characterization and relevant regulations. The lack of legal characterization exists even though a CDS is strikingly similar to an indemnity-insurance contract. This paper elucidates the common law principles of insurance like that of utmost good faith, indemnity and insurable interest and corresponds them with the framework of a typical CDS. Despite the uncanny resemblance, the opinion that treats CDSs as insurance contracts, remains highly contested. One of the pro-deregulation advocates – ISDA – has created its own set of regulations and a standard contract, called the Master Agreement, which more or less governs the otherwise virgin CDS market. In response, the RBI, too, has issued guidelines governing CDSs which, this paper argues, impliedly treat a CDS as a contract for insurance purposes. However, confusion still persists amongst the various stakeholders. This paper, therefore, argues that an express and clear legal characterization will provide a much-needed impetus to the slacking CDS market at present in India.*

**Keywords:** Credit Default Swap, indemnity-insurance contract, ISDA, Master Agreement, RBI Guidelines.

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## I. INTRODUCTION

A Credit Default Swap (“CDS”) is an agreement of indemnification by a protection seller to the protection buyer on a credit event, the happening of which inevitably causes some loss to the protection buyer. The purpose of such an agreement is, therefore, to hedge one’s credit risk on regular payment of an amount as premium to the protection seller.

Since a CDS offsets the risk attached to credit like loans, advances, bonds, etc. it is natural for such agreements to become popular among banks, insurance companies, hedge funds, and other financial institutions. This popularity can be induced from the notional value of the CDS market in 2008 when it peaked at \$57.8 trillion.<sup>43</sup> Despite the allegations that the CDS market was the primary cause of the 2008 global financial crisis,<sup>44</sup> the market has managed to maintain a value as high as \$5.8 trillion.<sup>45</sup> CDSs are highly contested contracts wherein one view is that these swaps help stabilize the banking sector,<sup>46</sup> while according to the other such swaps are “*financial weapons of mass destruction*”.<sup>47</sup>

Since the inception of CDS, these agreements have remained in the realm of a legislative vacuum. Their legal characterization has

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<sup>43</sup> OSKARI JUURIKALA, THE LAW AND ECONOMICS OF CREDIT DEFAULT SWAPS: DERIVATIVES REGULATION, INSURANCE LAW, AND RECENT FINANCIAL MARKET REFORMS 15 (2015), [hereinafter JUURIKALA].

<sup>44</sup> Martin Buffet, *How do CDOs and CDSs Influence the Crisis of 2008*, 6 LINGNAN JOURNAL OF BANKING, FINANCE AND ECONOMICS 17, 20 (2016).

<sup>45</sup> *Global Credit Default Swaps Market Study*, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION (Sept. 26, 2019), <https://www.isda.org/2019/09/26/global-credit-default-swaps-market-study/>.

<sup>46</sup> Alan Greenspan, Remarks at the Federal Reserve Bank of Chicago’s 41st Annual Conference on Bank Structure (May 5, 2005), [http://fraser.stlouisfed.org/docs/historical/greenspan/Greenspan\\_20050505.pdf](http://fraser.stlouisfed.org/docs/historical/greenspan/Greenspan_20050505.pdf).

<sup>47</sup> Warren E. Buffett, BERKSHIRE HATHAWAY INC., BERKSHIRE HATHAWAY INC. ANNUAL REPORT 2002, at 15 (February 2003), <http://www.berkshirehathaway.com/2002ar/2002ar.pdf>.

not been settled, which has grown concerns amongst the various stakeholders dealing with such agreements. Apart from the legislative vacuum, there also exists a lack of regulatory uniformity. The major question that lies is whether or not such contracts can be treated as insurance contracts. This dilemma has stumbled developed economies like the United States and the United Kingdom too.<sup>48</sup> Therefore, with no jurisdiction having a well-defined regulatory regime, it becomes fairly obvious that the same situation prevails in India too. The only rules that exist are in the form of guidelines issued by the Reserve Bank of India (“RBI”),<sup>49</sup> which has adopted a stringent and narrow approach towards the utilization of such contracts.

In such a legislative and regulatory vacuum, the International Swap and Derivatives Association (“ISDA”) has taken significant steps to homogenize and standardize CDS contracts through its ‘Master Agreement’ i.e., a standard template CDS agreement,<sup>50</sup> with the primary objective of reducing litigation and in turn have created a monopoly in the CDS market for themselves. The RBI too has implemented a modified version of this Master Agreement. Further, despite of there being a lack of proper classification, it can be universally accepted that CDSs fall under the purview of Contract Law as they are agreement between two consenting parties.<sup>51</sup>

This paper primarily aims to discuss the legal character of such agreements based on the common law principles of insurance and indemnity. Secondly, the paper discusses ISDA’s role in

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<sup>48</sup> See, Nathaniel Dutt, *Current United States Credit Default Swaps Regulatory Initiatives: A New World Standard or Just a Ploy*, 16 ILSA JOURNAL OF INTERNATIONAL AND COMPARATIVE LAW 170 (2009); JUURIKKALA, *supra* note 1 at 98.

<sup>49</sup> RESERVE BANK OF INDIA, GUIDELINES ON CREDIT DEFAULT SWAPS FOR CORPORATE BONDS ¶1 (2011) [hereinafter, GUIDELINES].

<sup>50</sup> See, INTERNATIONAL SWAP AND DERIVATIVES ASSOCIATION INC., 2002 ISDA MASTER AGREEMENT PROTOCOL, (July 15, 2003) [hereinafter MASTER AGREEMENT].

<sup>51</sup> POLLOCK & MULLA, THE INDIAN CONTRACT ACT, 1872 § 2.13 (15<sup>th</sup> ed. 2020).

monopolizing the CDS market through its Master Agreement and its various lacunae. Lastly, the paper critically analyses the Indian stance on such agreements based on the governing RBI Guidelines. However, before delving deep into the legality of such a complex instrument, one must be abreast with the technicalities of the same. Therefore, the first section deals with the economics or the basic framework of a CDS agreement.

## II. UNDERSTANDING CREDIT DEFAULT SWAPS

The terminology usually suggests a certain complexity attached to the concept, however, the basic framework of such contracts is very simple.

*“A CDS is a contract between two parties, whereby one party (protection buyer) pays a periodic premium in return for a promise by the other (protection seller) to compensate the loss of value of one or more reference obligations in the case of a credit event on those obligations.”<sup>52</sup>*

Further, according to Bank of England’s David Rule, a CDS is a contract wherein the *“protection seller receives a fee ex-ante for agreeing to compensate the protection buyer ex-post without providing any funding.”<sup>53</sup>*

To study the legal characterization of such contracts, one must be abreast with the technical jargon used while referring to or defining such contracts. Some important concepts are:

- **Reference Entity:** It is the entity who issues the reference obligation and against whose default, protection is sought.

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<sup>52</sup> JUURIKALA, *supra* note 1 at 16.

<sup>53</sup> David Rule, *The Credit Derivatives Market: Its Development and Possible Implications for Financial Stability*, BANK OF ENGLAND FINANCIAL STABILITY REVIEW 117, 118 (June 2001).

- **Reference Obligation:** It is the underlying credit which is being hedged.
- **Credit Event:** It includes events such as outright non-payment, insolvency of the reference entity, etc. Furthermore, this is a negotiable clause.<sup>54</sup>

For instance, a Company 'X' (Reference Entity) issues a bond for Rs.10000 (Reference Obligation) to a Bank 'Y'. To offset the probability of the losses 'Y' might suffer if 'X' were to default the payment, 'Y' goes to a third entity 'Z'. 'Z' agrees to take upon himself the credit risk of the bond worth Rs.10000 if some credit event were to occur if and only if 'Y' agrees to pay a premium at 5% of the underlying reference bond quarterly for a period of one year. Such a setup lies at the core of a CDS. Therefore, the purchase of a CDS may be seen as a short position on the credit risk of the reference entity.<sup>55</sup>

Since the market for CDS is of an over-the-counter ("OTC") nature,<sup>56</sup> the contracts are bilaterally negotiated thus giving the parties a choice over the terms of the final agreement. Finally, another crucial aspect of a CDS is the way in which the settlement is effected on a credit event. There are three different identified ways for settling:

- 1) **Physical Settlement:** The protection seller accepts the delivery of the failed underlying bond and pays the entire value to the protection buyer.

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<sup>54</sup> Anna Gelpern & Mitu Gulati, *CDS Zombies*, 13 EUROPEAN BUSINESS ORGANIZATION L. REV. 347, 361-362 (2012) [hereinafter Gelpern & Gulati].

<sup>55</sup> L. AMADEI, ET AL., CONSOB, DISCUSSION PAPER NO. 1, CREDIT DEFAULT SWAPS: CONTRACT CHARACTERISTICS AND INTERRELATIONS WITH THE BOND MARKET, at 6 (February 2011) [hereinafter AMADEI, ET AL.].

<sup>56</sup> JUURIKALA, *supra* note 1 at 17.

2) **Cash Settlement:** The protection buyer receives the sum of the bond or other amount as specified in the contract for the losses suffered due to the credit event

3) **Auction Settlement:** Opted for when a number of defaulted bonds, loans are to be settled. It may involve both cash and physical settlement and the final price of the bond is decided by the prevailing market conditions.<sup>57</sup> There are many more technicalities attached to an auction-based settlement, however, an elemental understanding is sufficient for the purposes of this paper.

To sum up, a CDS is a contract which aims to indemnify the owner of the bonds in case, the issuer of the bond defaults. Such a perception may lead one to look at CDSs the same way as insurance contracts. However, this opinion is a highly contested one and has contributed to the perpetual dilemma of the legal characterization of a CDS. Moreover, since its inception, the nature and kinds of CDSs have evolved from 'covered CDS' to both 'covered CDS' and 'naked CDS' (a CDS in which the buyer does not own the reference bond)<sup>58</sup> in today's time which has furthered the characterization dilemma.

### III. THE LEGAL CHARACTERIZATION CONUNDRUM

A CDS as a contract resembles a variety of other already established legal instruments including *inter alia* a contract of guarantee and a contract for insurance where the central purpose of the contract is to reimburse the party suffering a loss. However, since the fundamental structure of a contract of guarantee is embedded in

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<sup>57</sup> JEAN HELWEGE, ET AL., FEDERAL RESERVE BANK OF NEW YORK STAFF REP NO. 372, CREDIT DEFAULT SWAP AUCTIONS, at 5-7 (May 2009).

<sup>58</sup> Iñaki Aldasoro & Torsten Ehlers, *The Credit Default Swap Market: What a Difference a Decade Makes*, BIS QUARTERLY REVIEW at 8 n.13 (June 2018).

a tripartite set-up,<sup>59</sup> one can safely conclude that a CDS is not akin to a contract of guarantee.

However, with regards to insurance contracts, the question as to whether CDSs should fall under insurance law and regulation has always been a moot point. To demystify the same, one must delve deep into the structure of an insurance contract as well as delineate the principles that guide insurance law regulations.

A contract of insurance has been defined in the landmark case of *Prudential Insurance Company v. IRC* as:

*“A contract of insurance, then, must be a contract for the payment of a sum of money, or for some corresponding benefit such as the rebuilding of a house or the repairing of a ship, to become due on the happening of an event, which event must have some degree of uncertainty about it and must be of a character more or less adverse to the interest of the person effecting the insurance.”*<sup>60</sup>

Based on the above definition, the three essential elements of insurance contracts therefore are payment, uncertainty and adverseness.<sup>61</sup> Moreover, all insurance contracts, except life insurance and personal accident insurance,<sup>62</sup> are indemnity contracts.<sup>63</sup> Therefore, the common law principles of indemnity also have a bearing on insurance contracts. The indemnity aspect in insurance is the fact that the ‘actual loss suffered’ determines the

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<sup>59</sup> *New India Assurance Co. Ltd. v. Kusumanchi Kameshwara Rao*, (1997) 9 SCC 179; See, INDIAN CONTRACTS ACT, 1872 §126.

<sup>60</sup> *Prudential Insurance Company v IRC*, [1904] 2 KB 658, 663.

<sup>61</sup> English and Scottish Law Commissions Issues Paper 4, *Insurance Contract Law: Insurable Interest*, ¶7.19 (Jan. 14, 2008) [hereinafter English and Scottish Law Commission Issues Paper].

<sup>62</sup> *United India Insurance Co. Ltd. v. Kantika Colour Lab*, (2010) 6 SCC 449.

<sup>63</sup> Herbert S. Denenberg, *The Legal Definition of Insurance: Insurance Principles in Practice*, 30 THE JOURNAL OF INSURANCE 319, 329 (1963).

payment.<sup>64</sup> The legal requirement is that of an *ex post* determination of compensation<sup>65</sup> which can be attributed from the dictionary meaning of indemnification which is 'compensation'.<sup>66</sup> It is to hold the party harmless<sup>67</sup> against a specified loss or expense.<sup>68</sup>

Besides these, there are certain fundamental principles that are applicable to insurance law. These are the principles of utmost good faith and insurable interest.

A contract of insurance is a contract *uberrime fide* i.e. a contract of utmost good faith.<sup>69</sup> The only difference between a contract of insurance and any other contract is the compulsion of maintaining utmost good faith.<sup>70</sup> This requirement entails the duty to reveal material facts which would directly affect the amount of premium or the policy.<sup>71</sup> Not only is it mandatory to maintain good faith prior to the commencement of the policy but this requirement is of a continuing nature.<sup>72</sup> Both the insured and the insurer have a mutual duty of maintaining this heightened notion of good faith.<sup>73</sup> In India, this principle is applied rigorously.<sup>74</sup>

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<sup>64</sup> MALCOLM CLARKE, POLICIES AND PERCEPTIONS OF INSURANCE LAW IN THE TWENTY FIRST CENTURY 27 (2005).

<sup>65</sup> JUURIKALA, *supra* note 1 at 115.

<sup>66</sup> *Indemnify*, OXFORD DICTIONARY (3<sup>rd</sup> ed. 2010).

<sup>67</sup> T. F. Martin, *Contracts of Indemnity*, 4 COMMW. L. REV. 13, 13 (1906).

<sup>68</sup> *Firma C-Trade SA v. Newcastle Protection and Indemnity Association*, [1991] 2 AC 1 at 35, 36.

<sup>69</sup> *Insurance Law & Regulations in India*, NISHITH DESAI ASSOCIATES at 23 (2002), [http://www.nishithdesai.com/fileadmin/user\\_upload/pdfs/Insurance\\_Law\\_-\\_Regulations\\_in\\_India.pdf](http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Insurance_Law_-_Regulations_in_India.pdf). [hereinafter *Insurance Law in India*].

<sup>70</sup> *General Assurance Society Ltd. v. Chandumull Jain*, AIR 1966 SC 1644.

<sup>71</sup> Mokhamad Khoirul Huda, *An Obligation to Represent and Disclose Material Facts as a Good Faith in Life Insurance Contract*, 8 MEDITERRANEAN JOURNAL OF SOCIAL SCIENCES 53, 56 (2017).

<sup>72</sup> *United India Insurance co. Ltd v. M.K.J Corpn.*, (1996) 6 SCC 428.

<sup>73</sup> *Carter v Boehm*, (1766) 97 ER 1162.

<sup>74</sup> *Insurance Law in India*, *supra* note 27 at 24.

Insurable interest has been defined as “*a financial or other interest in preservation of the thing insured.*”<sup>75</sup> This interest must be such that the risk would by its proximate effect cause damage to the assured, that is to say, cause him to lose a benefit or incur liability.<sup>76</sup> Thus the presence of insurable interest fulfils the adverseness requirement. The absence of such an interest would, however, make the contract a wager and thus void in nature.<sup>77</sup> Moreover, the said interest must exist at the time of the inception as well as the time of the loss.<sup>78</sup> The common law views insurable interest as ‘factual expectation’ of a pecuniary loss.<sup>79</sup>

Applying these fundamental principles and elements of an insurance contract to a CDS, a couple of similarities can be culled out. Firstly, both the contracts provide for the payment of premium by the insured to the insurer. Secondly, the duty of the protection seller to pay the protection buyer arises on the happening of a specified event thus fulfilling the ‘indemnity’ requirement. Moreover, like insurance contracts, a CDS, too, is a bipartite agreement. This is because there are two parties involved in such contracts namely, the insurer and the insured, in case of an insurance contract and the protection buyer and the protection seller, in case of a CDS.

Thus, the fundamental framework of both the contracts is similar. Furthermore, the creditor can be said to have insurable interest in the debt, since the non-fulfilment of the obligation on the happening of a specified credit event will render the creditor an actual pecuniary loss. The physical settlement or cash settlement of the reference

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<sup>75</sup> *Lucena v. Craufurd*, (1806) 2 B & P 269 HL.

<sup>76</sup> *Seagrave v Union Insurance Co. Ltd.*, (1886) LR 1 CP 305.

<sup>77</sup> *Tomlison (Haulers) Ltd. v. Hoplurane*, 1966 (1) AC 418.

<sup>78</sup> Telford F. Hollman, *The Doctrine of Insurable Interest*, 1978 INS. L.J. 160, 164 (1978).

<sup>79</sup> Julian Long, *The Concept of Insurable Interest and the Insurance Law Reform Act 1985*, 7 AUCKLAND U. L. REV. 80, 89 (1992).



obligation may compensate for the loss and hold the insured harmless.

However, the principle of utmost good faith is still not applicable to a CDS. The happening of a credit event is determined by publicly disclosed information and the duty of notifying the same lies with the protection buyer. This may not be a problem in the case of bonds issued by public companies. However, the imposition of utmost good faith may increase the cost of the contract in other cases since it imposes a burdensome duty on one party. This would be detrimental to the commercial value of such contracts. But, this principle's adherence will provide certain stability to the market which in turn would promote the idea of characterizing a CDS as an indemnity-insurance contract across all jurisdictions.

As far as 'naked CDSs' are concerned, the principle of insurable interest is absent.<sup>80</sup> However, in a country like India, with strong anti-gambling laws and a stringent stance against wagering agreements, 'naked CDSs' are void in nature.

Another obstacle in the classification of a CDS as an insurance contract is that in today's time, there are non-indemnity insurance policies for property as well.<sup>81</sup> In other words, these are valued policies that pay out a pre-decided sum on loss of property on the happening of a specified event without regard to the actual pecuniary loss resulted by such event.<sup>82</sup> Thus the classification of CDS as a non-indemnity insurance would inadvertently affect the

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<sup>80</sup> See, Robin Potts, *Credit Derivatives: Opinion*, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, ¶5 (1997) [hereinafter, Potts, *Credit Derivatives: Opinion*].

<sup>81</sup> Oskari Juurikkala, *Credit Default Swaps and Insurance: Against the Potts Opinion*, 26 JOURNAL OF INTERNATIONAL BANKING LAW AND REGULATION 128, 137 (2011) [hereinafter, Juurikkala, *Against the Potts Opinion*].

<sup>82</sup> English and Scottish Law Commissions Issues Paper, *supra* note 19, ¶3.64.

requirement of insurable interest<sup>83</sup> since then, the amount becomes merely contingent on the credit event.

Another characteristic distinction is the terminology used in a CDS agreement. The terms insurer, insured, policyholder, fortuitous loss, etc.<sup>84</sup> are typically avoided or omitted in a CDS contract.<sup>85</sup> However, this is not of much relevance as in a contract of insurance the substance is of value more than the form.<sup>86</sup> Otherwise it would be an easy way for business agreements to avoid insurance regulations.<sup>87</sup> The substance here refers to the obligation of the insurer.<sup>88</sup> Such an approach emphasises on the ultimate purpose of the contract rather than reading the contract as it is which suggests that a CDS should be characterized as an insurance contract.

In spite of significant similarities in the nature and purpose of an insurance contract and a CDS, there are certain ulterior motives involved in not bringing them under the ambit of insurance law. Firstly, to issue an insurance policy requires a valid certificate of registration which is issued with additional regulatory burdens such as maintaining loss reserves, capital adequacy, disclosures, etc. Secondly, the necessity of insurable interest, without which an insurance contract cannot be made enforceable, rules out the possibility of speculative transactions where the protection buyer is

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<sup>83</sup> Juurikkala, *Against the Potts Opinion*, *supra* note 39 at 138.

<sup>84</sup> See, *Glossary of Insurance Terms*, NATIONAL INSURANCE BROKERS ASSOCIATION (July 2006), [https://www.niba.com.au/resource/Glossary\\_of\\_Insurance\\_Terms%20A-Z.pdf](https://www.niba.com.au/resource/Glossary_of_Insurance_Terms%20A-Z.pdf).

<sup>85</sup> *Sample Term Sheet for a Credit Default Swap Trade*, YIELDCURVE.COM (September 2004), [http://www.yieldcurve.com/Mktresearch/LearningCurve/CDS\\_SampleTermSheet.pdf](http://www.yieldcurve.com/Mktresearch/LearningCurve/CDS_SampleTermSheet.pdf).

<sup>86</sup> *Fuji Finance Inc. v. Aetna Life Insurance Co. Ltd.*, [1997] Ch. 173 (C.A.); FINANCIAL SERVICES AUTHORITY, PERIMETER GUIDANCE MANUAL, ¶6.5.4(1) (June, 2020), <https://www.handbook.fca.org.uk/handbook/PERG.pdf>.

<sup>87</sup> Jan Hellner, *The Scope of Insurance Regulation: What Is Insurance for Purposes of Regulation?*, 12 AMERICAN J. OF COMPARATIVE LAW, 494, 500 (1963).

<sup>88</sup> *In re Sentinel Securities*, [1996] 1 WLR 316.

actually “shorting” the liabilities of a company without any underlying asset.<sup>89</sup> Since, the economic costs and legal implications of characterizing CDSs as insurance contracts outweigh the benefits, the void as to whether they should be treated as insurance contracts continue to exist.

#### IV. ISDA MASTER AGREEMENT: THE SAVING GRACE?

The ISDA released a Master Agreement first in 1987 with the objective of standardizing the terms governing all OTC derivatives transactions. Subsequently, modifications were made which gave rise to Master Agreement 1992 and Master Agreement 2002. This Master Agreement contains key definitions, obligations, representations, etc. which are essentials while framing a CDS. This initiative was undertaken so as to reduce costly litigation by creating their own set of regulations.

ISDA is one of the key organizations that has championed for public deregulation of CDSs. It was ISDA that sought the legal opinion of Robin Potts QC, according to whom the rights of the protection buyer do not depend on any insurable interest,<sup>90</sup> thus advocating for a self-regulated environment. Furthermore, the authority of ISDA has gained in importance for a number of reasons. Firstly, the courts tend to apply the terms of the contract as they are in case of complex commercial contracts since the parties involved are capable to understand the repercussions of any fallout thus insisting on the notion of party autonomy.<sup>91</sup> Secondly, in such a scenario of self-regulation, standardization provided by the Master Agreement reduces the time and cost of entering into such agreements. Thirdly, along-with the Master Agreement, ISDA has

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<sup>89</sup> See, JUURIKALA, *supra* note 1 at 117, 118.

<sup>90</sup> Potts, *Credit Derivatives: Opinion*, *supra* note 38.

<sup>91</sup> *Perpetual Trustee Co. Ltd. v. BNY Corporate Trustee Services Ltd.* [2009] EWCA (Civ) 1160.

developed an entire architecture revolving around OTC transactions including *inter alia* annexes, definitions, protocols, guidelines, bridges, etc.<sup>92</sup> It resembles an all-encompassing industry-wide constitution.<sup>93</sup> Lastly, the regulations proposed are market sensitive and flexible in nature since ISDA itself is a major stakeholder in the finance market.<sup>94</sup>

ISDA has made ground-breaking efforts in homogenizing the terms of a CDS contract. The rather unambiguous clauses involve the specification of the reference entity, the reference obligation, the effective and scheduled termination date. Premiums too have now been fixed at 25, 100, 500 or 1000 basis points.<sup>95</sup> Contracts which provide for physical settlement are generally straight-forward, however, in case of cash settlements, with the addition of the Big Bang Protocol (“**BBP**”), all such settlements are to be done through an auction mechanism where the calculation agent is the Determination Committee (“**DC**”) of the ISDA<sup>96</sup>. However, prior to the BBP, the protection seller was the calculating agent.<sup>97</sup> With the implementation of the BBP, the ISDA has ventured into creating its own dispute resolution framework by endowing upon the DC adjudicatory powers.

The most disputable clause in the entire contract is that of the credit events covered under a CDS. ISDA has restricted the credit events that determine liquidation of a contract to the following:

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<sup>92</sup> Joanne P. Braithwaite, *Standard Form Contracts as Transnational Law: Evidence from the Derivatives Markets*, 75 MODERN L. REV. 779 (2012) [hereinafter Braithwaite].

<sup>93</sup> Gelpern & Gulati, *supra* note 12 at 357.

<sup>94</sup> JUURIKKALA, *supra* note 1 at 205.

<sup>95</sup> AMADEI, ET AL., *supra* note 13 at 14.

<sup>96</sup> *Id.* at 13.

<sup>97</sup> Jan Roman, *Credit Default Swap*, 10, <http://janroman.dhis.org/finance/Kreditrisk/Credit%20default%20swap.pdf>. (last visited June 12, 2020) [hereinafter Roman].

a) Bankruptcy, as defined under ISDA 2002 Master Agreement.<sup>98</sup>

b) Obligation acceleration is the event wherein the reference obligation becomes due and payable before the time when such an obligation would otherwise have been due and payable. This event occurs when a certain sum, above a decided minimum threshold, is accelerated.

c) Obligation default is the event where the reference obligation becomes due and payable as a result of a default by the reference entity before the due date. It is pertinent to note that obligation acceleration is a subset of obligation default.

d) Failure to pay what is due under an obligation.

e) Repudiation/Moratorium are the particular steps that the reference entity or the sovereign might take to disavow obligations under its indebtedness.<sup>99</sup>

f) Restructuring involves either a reduction in the interest rate or in the amount of principal, deferral of dates for the payment of interest or principal or a change in ranking that causes subordination to obligations, or any change in the currency of the payments interest and principal.<sup>100</sup>

The parties are free to negotiate on these credit events. However, the determination of a credit event is not the responsibility of the calculation agent but is rather a matter of fact, information of which is to be made available by the protection buyer to the protection

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<sup>98</sup> See, MASTER AGREEMENT, *supra* note 8 §5(a)vii.

<sup>99</sup> Scott O'Malia, *The First Rule About CDS: Don't Talk About CDS (Unless You've Read the Contract)*, ISDA (Nov. 8, 2011), <https://www.isda.org/2011/11/08/the-first-rule-about-cds-dont-talk-about-cds-unless-youve-read-the-contract/>.

<sup>100</sup> Antje Berndt, Robert A. Jarrow & Choongoh Kang, *Restructuring risk in credit default swaps: An Empirical Analysis*, 117 STOCHASTIC PROCESSES AND THEIR APPLICATIONS 1724, 1726 (2007).

seller with support from publicly disclosed information along with a credit event notice.<sup>101</sup> Thus, there remains some scope of judicial intervention to determine the existence of a credit event in case there is a conflict.

In spite of the ambiguity in the mechanism determining the occurrence of credit events, litigation on CDSs has been unsubstantial,<sup>102</sup> due to the heavy costs involved and the market-friendly nature of the clauses in the ISDA Master Agreement governing all such OTC agreements. Thus, in spite of the ISDA routing for the deregulation of CDSs, the Master Agreement may be the silver lining in the current state of anarchy that prevails in the CDS market.

#### V. GOVERNING INDIAN GUIDELINES: A CRITICAL ANALYSIS

CDS is a risk management product offering participants the ability to hedge off credit risk and also to assume such risk which otherwise may not be possible.<sup>103</sup> This is the definition of a CDS prescribed by RBI. It is the only regulatory body that has issued relevant guidelines for the CDS market. The CDS market in India is insignificant,<sup>104</sup> as compared to that of the United States or United Kingdom, and this insignificance can be attributed to these guidelines which have aimed to create a regime without attempting to characterize such complex commercial instruments.

The Indian CDS market is limited to listed corporate bonds and unlisted but rated corporate bonds. The guidelines have expressly disallowed CDSs for trading purposes by making naked CDS protection unmaintainable. Moreover, the swap amount has also

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<sup>101</sup> Roman, *supra* note 55.

<sup>102</sup> Braithwaite, *supra* note 50 at 790.

<sup>103</sup> GUIDELINES, *supra* note 7.

<sup>104</sup> *RBI New CDS Guidelines: Feeble Effort to Start a Non-Starting Product*, VINOD KOTHARI CONSULTANTS (Jan. 9, 2013), <http://vinodkothari.com/rbi-new-cds-guidelines-feeble-effort-start-non-starting-product/>.

been capped at the face value of the underlying bond held by the protection buyer.<sup>105</sup> Thus, the guidelines do take certain precautions but fails to address the characterization issue. In addition, the protection sellers are restricted to commercial banks and Non-Banking Financial Companies (“NBFC”) while the users include a wider variety of entities.<sup>106</sup> It is pertinent to note here that Insurance Companies have been left out from the purview of market-makers which hints at the RBI’s intention to not characterize such instruments as insurance contracts. Moreover, the parties to such a contract as well as the reference entity must necessarily be a single legal resident entity,<sup>107</sup> meaning, an entity incorporated in India or having some presence in the Indian market. The above guidelines along with these observations highlight the conservatory outlook of the RBI towards such novel instruments.

Despite the lack of clarity on legal characterization and the traditional outlook towards such contracts, the RBI has taken significant efforts in standardizing the agreements in line with the ISDA Master Agreement. The RBI has mandated the Fixed Income Money Market and Derivatives Association of India (“FIMMDA”) to frame two sets of documentation – one covering transaction between a user and a market-maker while the other covering a transaction between two market-makers.<sup>108</sup> Instructions to constitute a DC have also been issued, which would contain both market participants and FIMMDA.<sup>109</sup> For definitions, the guidelines have occasionally referred to the Master Agreement. However, there are certain drawbacks in the otherwise meticulous framing of the guidelines governing a CDS. It is the exclusion of ‘restructuring’ as a credit event if not approved under Board for Industrial and

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<sup>105</sup> See, GUIDELINES, *supra* note 7, ¶2.5.

<sup>106</sup> *Id.* ¶2.1.1.

<sup>107</sup> See, FOREIGN EXCHANGE MANAGEMENT ACT, 1999 §2(v).

<sup>108</sup> GUIDELINES, *supra* note 7, ¶2.9.

<sup>109</sup> See, *Id.* ¶2.11.3.

Financial Reconstruction (“BIFR”) and Corporate Debt Restructuring (“CDR”).<sup>110</sup> Moreover, users are only allowed to physically settle the contract. In a sense, this has curtailed the autonomy of the parties from entering into a CDS. Such a curtailment is *contra* the general rule of enforcing the terms of the contracts as they are in the case of complex and sophisticated contractual agreements.<sup>111</sup>

Withal the stringent guidelines of eligibility and applicability of CDSs, RBI has also imposed rigid capital adequacy norms on the market-makers along with case-by-case approval for NBFCs to act as market-makers. Moreover, rigorous audit discipline standards and periodic review processes have made the overall costs of such a contract high. Minimal leeway in the form of extending CDSs so as to include loans may expand the market manifold. Furthermore, clarity as to the legal characterization can give a much needed impetus to such *sui generis* contracts and make them more mainstream in the Indian economic and legal sphere.

## VI. CONCLUSION

The legal characterization of a complex commercial contract such as that of a CDS has far-reaching implications. It may either reduce or enhance the commercial value of such contracts. Due to the legislative and regulatory void, the gross notional value of the CDS market has plummeted. In spite of this, the CDS market is of significance due to its potential.

A CDS is a bilateral credit-risk hedging tool. In efforts to characterize a CDS, in lieu of the aforementioned definition, similarities have been drawn between a CDS and a contract of insurance. However, it is pertinent to note that, based on the

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<sup>110</sup> *See, Id.* ¶2.11.1.

<sup>111</sup> *Perpetual Trustee Co. Ltd. v. BNY Corporate Trustee Services Ltd.*, [2009] EWCA (Civ) 1160.



common law principles of insurance, certain differences too can be culled out which further the dilemma of its legal characterization. This dominant question has persisted, thanks to strong anti-regulation lobbying against the bureaucracy and capital adequacy norms attached with insurance regulations.

In such a vacuum, the ISDA, an ardent anti-regulation advocate, has created its own internal system of regulation and an industry-wide constitution. The Master Agreement standardizes the clauses in the contract. Moreover, committees and protocols have been constituted to adjudicate on any dispute arising between contracting parties thus covering all tasks which would otherwise have been governed by the States through legislations, regulations and judicial decisions. From the traction ISDA has gained due to the monopoly over the CDS market, it is but obvious that the characterization of CDSs as insurance contracts is not in their best interests. This is exactly why there is a need to take into account factors, other than the ISDA, into consideration while concluding on its legal character.

In the Indian context, the RBI guidelines, too, leave the question of legal characterization largely unanswered while imposing stringent restrictions on the market participants to enter into such contracts. The conservative nature of the guidelines have made the cost of entering into such contracts high. It is submitted that, since the Indian stance already sees a CDS as a hedging tool rather than a trading tool, our best interest lies in characterizing such contracts as indemnity-insurance contracts. Such an approach would fall in line with the loss reserves and capital requirements to be maintained by the market-makers since, insurance companies too are obligated to maintain certain standards in this regard. With some clarity and improvements, in the form of allowing unrated corporate bonds to be hedged, the Indian CDS market will receive the much needed jump start and catch up with the rest of the developed economies.

In spite of the benefits of characterizing a CDS as an indemnity-insurance contract, there still exists scope for further introspection with regards to 'what constitutes insurable interest' especially in the context of the interest of a shareholder of the reference entity in the reference bond and the right of such shareholder to enter into a CDS without owning the underlying reference bond. Therefore, there is a need to further examine the scope and extent of insurable interest with reference to a CDS contract.

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## PROTECTING THE RIGHTS OF CHILDREN UNDER THE DRAFT PERSONAL DATA PROTECTION BILL

- Divya Pinheiro\*

### ABSTRACT

*The right to privacy is a fundamental right that must be guaranteed to all citizens. In its efforts to do so, the legislature has drafted the Personal Data Protection Bill in India to safeguard and protect the interests of its vast population. The Bill aims to define what personal data and sensitive personal data are. It further imposes duties on those who collect such information to ensure that adequate information is provided to those whose information has been collected and processed so that they are in a prime position to decide for themselves if their personal information can be collected and used by such data collectors. Within this regime, one group of particularly vulnerable individuals seem to have been overlooked, that of children. Children can be differentiated from adults due to their perceived lack of understanding of the consequences of their actions. Children require special protection under privacy laws as they are less likely to comprehend the risks associated with the processing of data and are more likely to be influenced by the results of such processed data. This article aims to analyse the provisions in the draft Personal Data Protection Bill, and to examine whether it lays down adequate requirements to ensure that the best interests of children are taken care of. The article also examines the steps taken in the jurisdictions of the European Union and the United States of America to protect the rights of children on the internet. It further evaluates the shortfalls of the Indian regulatory framework in protecting the rights of children in a digital world. Finally, the article offers suggestions that could be incorporated into the draft Bill to ensure that the rights of children are adequately protected.*

**Keywords:** children, data processing, privacy law, consent, personal data, PDPB

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## I. INTRODUCTION

“The Right to Privacy is protected as an intrinsic part of the right to life and personal liberty under Article 21 and as part of the freedoms guaranteed by Part III of the Constitution.” With these words, the Supreme Court of India, in the landmark judgement of *K.S. Puttaswamy v. Union of India*<sup>1</sup> established the Right to Privacy in the country. The concept of ‘private life’ is a broad term which cannot be accorded an exhaustive definition. It includes both the physical and psychological integrity of a person and therefore includes multiple facets of a person’s identity such as name, gender, sexual orientation and the like. It includes personal information that a person would not ordinarily expect to be published without consent.<sup>2</sup> However, providing citizens with mechanisms that effectively protect this Right to Privacy remains a goal that has yet to come to fruition. The draft Personal Data Protection Bill, 2019<sup>3</sup> (“**PDPB**”) attempts to provide a form of protection against the use of personal digital data of citizens.

The internet is a vast network on which people often give out more information about themselves than they might have ordinarily anticipated. Information disclosed on digital platforms are used by both the State as well as private corporations for a variety of reasons that range from automated data processing to the use of data to streamline and focus marketing. This data is collected both upfront as well as discreetly in the form of cookies on websites. The PDPB was thus proposed as a comprehensive data protection mechanism. The Bill has taken inspiration from the European Union’s (“**EU**”) General Data Protection Regulation (“**GDPR**”) through which

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<sup>1</sup> (2017) 10 SCC 1.

<sup>2</sup> *Axel Springer AG v. Germany*, App no 39954/08 (ECHR, 7 February 2012).

<sup>3</sup> The Personal Data Protection Bill, 2019,

[http://164.100.47.4/BillsTexts/LSBillTexts/Asintroduced/373\\_2019\\_LS\\_Eng.pdf](http://164.100.47.4/BillsTexts/LSBillTexts/Asintroduced/373_2019_LS_Eng.pdf).

Indian data subjects are granted extensive data protection rights. The Bill also imposes restrictions on the collection and processing of sensitive and personal data.

While ensuring that privacy rights of adult users of the internet is protected is itself a difficult task, it is also important that any legislation that aims to protect the privacy rights of its citizens must also take in to account the rights and specific issues for the more vulnerable groups of its citizenry. Of these groups, children are one of the most vulnerable. Children constitute a substantial chunk of internet users and personal and sensitive information of children is often collected from them *via* their usage. The risk posed to children is exacerbated by their inability to understand the full extent of the consequences that can arise out of consent to collect, process and use sensitive and personal data.

This article therefore attempts to analyse the provisions of the PDPB from the lens of a child user of the internet by first, analysing the need for special protection of children using the internet; second, analysing the provisions that pertain specifically to children in this draft legislation and then comparing the provisions of the PDPB to the EU's GDPR and the congruent laws in the United States. The article then aims to offer suggestions to the PDPB that will ensure better protection of data of child users of the internet in India.

## II. NEED FOR SPECIAL PROTECTION OF CHILDREN ON THE INTERNET

It is estimated that one in three users of the Internet today are children.<sup>4</sup> Advancements in technology can provide children with new sources of information, education and opportunities. However,

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<sup>4</sup> Sonia Livingstone, John Carr, & and Jasmina Byrne, *One in Three: Internet Governance and Children's Rights*. Global Commission on Internet Governance, CENTRE FOR INTERNATIONAL GOVERNANCE INNOVATION AND THE ROYAL INSTITUTE OF INTERNATIONAL AFFAIRS, (Nov. 2015)

[https://www.cigionline.org/sites/default/files/no22\\_2.pdf](https://www.cigionline.org/sites/default/files/no22_2.pdf).

with these technological developments arise questions of how prepared children throughout the world are to exercise their rights in a society that is going increasingly digital.<sup>5</sup>

The United Nations Convention on the Rights of Child (“UNCRC”)<sup>6</sup> lays down a wide range of child rights that are affected by these advancements in digital technology, both positively and negatively. Studies have shown that computer usage and access to the internet does promote a certain amount of cognitive development in children, with computer-literate children demonstrating better social skills when compared to their counterparts.<sup>7</sup> Thus, digital media when used right can promote additional avenues of complying with children’s rights to expression,<sup>8</sup> participation<sup>9</sup> and development.<sup>10</sup> On the other hand, it has also been found that access to the internet has not had significant impacts on the academic achievement and cognitive skills of children,<sup>11</sup> whilst having a negative impact on their emotional health and well-being.<sup>12</sup> This can affect the import of Article 6<sup>13</sup> which recognises the right of children to survival and development. Children today use the internet both as a source of information as well as a source of entertainment; it is found that they not only

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<sup>5</sup> UNICEF, *The State of the World’s Children 2017. Children in a Digital World* (2017), [https://www.unicef.org/publications/files/SOWC\\_2017\\_ENG\\_WEB.pdf](https://www.unicef.org/publications/files/SOWC_2017_ENG_WEB.pdf).

<sup>6</sup> United Nations Convention on the Rights of Child, United Nations Treaty Series, vol. 1577, Jan. 15, 1992.

<sup>7</sup> Alper T. Kumtepe, *The Effects of Computers on Kindergarten Children’s Social Skills*, 5 TOJET, 52-57 (2006).

<sup>8</sup> *supra* note 6, art. 13.

<sup>9</sup> *Id.* art. 12.

<sup>10</sup> *Id.* art. 15.

<sup>11</sup> Ofer Malamud, Santiago Cueto, et. al. *Home Internet Access and Child Development*, VOXEU (Mar. 8, 2019), <https://voxeu.org/article/home-internet-access-and-child-development>.

<sup>12</sup> Emily McDool, Philip Powell, et.al., *The Internet and Children’s Psychological Wellbeing*, 69 J. Health Econ 1, 2 (2020).

<sup>13</sup> *supra* note 6, art. 6.

believe that access to internet is their right<sup>14</sup> but are also increasingly aware of the risks that they might come across online.<sup>15</sup>

One of the primary risks that children encounter online is the risk to privacy. There may be instances where children share their information with strangers online, which, when disclosed could prove to be personal or sensitive information.<sup>16</sup> Research has shown that although children who use the internet are aware of their rights, they are less likely to have a comprehensive understanding of the consequences of the infringement of privacy by both the State as well as commercial players.<sup>17</sup> As children use the internet and navigate mobile apps, data about them is collected by both public actors as well as businesses.<sup>18</sup> Studies show that young children often know very little of common internet business practices such as sending “cookies” to track user information and do not completely understand why such information should not be shared online.<sup>19</sup> Such personal and sensitive data pools are predominantly utilised by private companies and include information of children of a very young age. These private companies can then sell such data which is further used for advertisement strategies and can also be used by insurance companies and many other third parties which may lead to unprecedented consequences in the future.<sup>20</sup> Often information

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<sup>14</sup> UNICEF, *supra* note 5.

<sup>15</sup> Ingrida Milkaite and Eva Lievens, *Children's Right to Privacy and Data Protection Around the World: Challenges in the Digital Realm*, 10 EU J. L&T, 1, 1 (2019).

<sup>16</sup> *Id.*

<sup>17</sup> Livingstone, S, *Children: A Special Case for Privacy?* 46 (2) InterMEDIA, <http://www.iicom.org/intermedia/intermedia-july-2018/children-a-special-case-for-privacy> .

<sup>18</sup> Children's Commissioner, *'Who knows what about me,'* <https://www.childrenscommissioner.gov.uk/publication/who-knows-what-about-me/> .

<sup>19</sup> Grace Chung, Sara M. Grimes, *Data Mining the Kids: Surveillance and Market Strategies in Children's Online Games* 30 CAN. J. COMMUN. 527, 531 (2006).

<sup>20</sup> Milkaite & Lievens, *supra* note 16.

collected in this manner is used by marketers to cluster population according to geodemographic type. This results in a form of social sorting where differential treatment of services, referred to as 'digital redlining' or 'weblining,' occurs as a consequence of customers being categorised on the basis of their relative worth.<sup>21</sup> This presents a serious issue especially when such information is collected from children don't have as much knowledge of the potential consequences and appropriateness of such data exchange. Therefore, the right of a child to privacy as prescribed under Article 16 of the UNCRC which mandates that no child be subjected to 'arbitrary or unlawful interference with his or her privacy, home, correspondence or to any attack to their honour or reputation'<sup>22</sup> is at risk in this increasingly digitised world.

The importance of a Right to Privacy for 'everyone' has long been deliberated upon. While attempts have been made at both a national and international front to crystallise the same, the discussion does not normally revolve around the protection of children and their digital data. The fact that children require enhanced protection on the internet is an issue that has not been given its due consideration.<sup>23</sup>

The PDPB defines as data principal as a "natural person to whom the personal data" refers to.<sup>24</sup> Since, all data principals are not equally vulnerable, it is of utmost importance that the manner in which the personal data of children is processed is given special attention. This concern also imposes an obligation on national supervisory authorities to ensure that due care and attention is given to activities that are specifically targeted at children. Public

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<sup>21</sup> David Lyon, *Surveillance as Social Sorting: Computer Codes and Mobile Bodies*, In D. LYON (ED.), *SURVEILLANCE AS SOCIAL SORTING: PRIVACY, RISK AND DIGITAL DISCRIMINATION* 13-30 (Routledge 2003).

<sup>22</sup> *supra* note 6, art. 16.

<sup>23</sup> Livingstone, *supra* note 18.

<sup>24</sup> *supra* note 3, S.3(14),



awareness must be promoted to ensure that the risks, rules safeguards and rights in relation to such data processing is mitigated to the best possible extent.<sup>25</sup>

### III. PRIVACY RIGHTS OF CHILDREN UNDER THE DRAFT PDPB

The draft Indian law for the protection of privacy on the internet provides protection to both adults and children who use the internet from having their data misused by data fiduciaries<sup>26</sup> (data fiduciaries refers to the person, State or organisation that determines the process or means of processing personal data) or by data processors<sup>27</sup> (data processors refers to a person, State or organisation that possesses personal data of another on behalf of the data fiduciary; a data processor is not an employee of the data fiduciary). In furtherance of such protection, the draft PDPB categorises data into certain subcategories.

Firstly, personal data<sup>28</sup> which relates to a natural person who can be directly or indirectly identified as having any specific characteristic, trait, attribute, or any other feature by which he or she can be identified as such natural person either through individual characteristic feature or through a combination of such feature or through a mixture of such features and other information. Secondly, the Bill also identifies data as 'sensitive personal data,'<sup>29</sup> which includes personal data relating to passwords, financial data, health data, sexual orientation, biodata, genetic data, gender, caste or tribe, political or religious associations or any other data specified as such by the data protection authority.

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<sup>25</sup> Silviu-Dorin Schiopu, *Brief Considerations on Processing a Child's Personal Data*, 6 *JUS ET CIVITAS: A JOURNAL OF SOCIAL AND LEGAL STUDIES* 23 (2019).

<sup>26</sup> *supra* note 3, S.3(13),

<sup>27</sup> *Id.* S. 3(15).

<sup>28</sup> *Id.* S. 3(28).

<sup>29</sup> *supra* note 3, S.3(36),

A child is defined under the PDPB as, 'a data principal who is below 18 years of age.'<sup>30</sup> The rationale behind concluding that the age of majority for the purposes of the Bill was 18 years was based on the age of majority as defined under the Indian Contract Act, 1872.<sup>31</sup> The Justice Srikrishna Committee Report justified this import on the grounds that the provision of consent for data sharing is often interwoven with the consent to contract.<sup>32</sup> However, given that in reality, children interact with data fiduciaries from a much younger age than 18, a requirement stipulating age verification and parental consent can weaken a child's ability to understand and then choose the manner in which their data can be used.<sup>33</sup> Such requirements take away from legal minors' effective participation in decisions about the processing of their data, particularly when the nature of contracts entered into on the internet are often vastly different from those entered into in the offline world. The issue, therefore, seems to be the determination of such crucial issues on the basis of laws that were designed with a different societal situation in mind and results in a derogation from fundamental principles such as principles such as a child's right to self-determination and autonomy in decision making.<sup>34</sup>

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<sup>30</sup> *Id.* S. 3(8).

<sup>31</sup> S.11, Indian Contract Act, NO. 9 of 1872, INDIA CODE (1872).

<sup>32</sup> *A Free and Fair Digital Economy: Protecting Privacy, Empowering Indians.*, Committee of Experts under the Chairmanship of Justice B.N. Srikrishna, 44, [http://meity.gov.in/writereaddata/files/Data\\_Protection\\_Committee\\_Report-comp.pdf](http://meity.gov.in/writereaddata/files/Data_Protection_Committee_Report-comp.pdf).

<sup>33</sup> *The Centre for Internet and Society's Comments and Recommendations to the Personal Data protection Bill* <https://www.medianama.com/wp-content/uploads/Centre-for-Internet-and-Society-Submission-India-Draft-Data-Protection-Bill-Privacy-2018.pdf>.

<sup>34</sup> Gautam Bhatia, *India Needs to Acknowledge the Gaps in Data Protection and Rights of Children* (10 Aug 2018, 08:27 PM IST), HINDUSTAN TIMES, <https://www.hindustantimes.com/analysis/india-needs-to-acknowledge-the-gaps-in-data-protection-and-rights-of-children/story-bxBrYtqXylgPou2yADe3xJ.html>.

The EU's GDPR under Article 8 allows the personal data of a child above 16 years of age where necessary parental consent has been received to be processed; the GDPR also permits member States to reduce this parental consent age bar up to the age of 13 years.<sup>35</sup> The United States in its Children's Online Privacy Protection Act ("COPPA") sets the age limit for a child at 13 years.<sup>36</sup> Therefore, the Indian standard of fixing the age of consent of a child on the internet at 18 years seems redundant and not in-tune with recent developments in the international arena.<sup>37</sup>

Recognising the importance of protecting the rights of citizens in the digital realm, the PDPB lays down certain rights that a data principal can avail. Of these rights, some rights can only be availed by data principals that are deemed to be children and the rest apply irrespective of the age of the minor.

#### *A. General Rights of a Data Principal*

Chapter V (Article 17 to 21) lays down the primary rights of a data principal under the PDPB. These rights include rights to confirmation and access; correction; data portability; and to be forgotten.

A data principal has the right to obtain information about the collection and processing of his data by a data fiduciary. In this regard, the data principal can find out whether the data fiduciary has or is collecting his personal information. Additionally, the data principal may seek a summary of such collected personal information as well as a summary on the manner in which such personal information has been collected.<sup>38</sup> The Bill also provides

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<sup>35</sup> *EU General Data Protection Regulation (GDPR): Regulation (EU) 2016/679, art.8.*

<sup>36</sup> *Children's Online Privacy Protection Act, §§ 6501–6506 (Pub. L. 105–277, 112 Stat.).*

<sup>37</sup> *Centre for Internet and Society, supra note 38.*

<sup>38</sup> *supra note 3, S.17,*

certain grounds<sup>39</sup> for the processing of data without the consent of the user. However, in such cases notice as under Section 7(1)(e) must be provided. While the inclusion of such a provision benefits users, the exception that applies in cases where the provision of notice could “substantially prejudice” the processing of personal data seems to take away these benefits.<sup>40</sup> Allowing such broad exemptions reduces transparency in the functioning of data fiduciaries and adversely affects the rights of users to control the manner in which their information may be processed.<sup>41</sup>

A data principal can further request that the personal data collected by a data fiduciary be corrected or updated. Although a data fiduciary may refuse to correct or update information in accordance with such a request if it feels that such a change is unnecessary, and can do so by providing relevant justification; the data principal still has the right to record their objection to such personal information. There exists a duty imposed on the data fiduciary to inform the data principal of any changes to their personal information as well as any disclosure of such information.<sup>42</sup> The Bill also mandates a data fiduciary to inform data principals in case of breach of information,<sup>43</sup> however, even this right is limited in its impact in allowing data fiduciaries to only send based on the severity of harm and need of action on the part of the data principal. Further, any urgency in ensuring that such information is passed on is diluted by the requirement that such notice must pass through the data protection authority.

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<sup>39</sup> *Id.* S. 12.

<sup>40</sup> *Id.* S. 7(3).

<sup>41</sup> Dvara Research, *Initial Comments on the Personal Data Protection Bill, 2019* (Jan. 16, 2020) <https://www.dvara.com/research/wp-content/uploads/2020/01/Initial-Comments-on-the-Personal-Data-Protection-Bill-2019.pdf>.

<sup>42</sup> *supra* note 3, S.18.

<sup>43</sup> *Id.* S. 25.

A data principal has the right to receive data given to, obtained by or generated by the data fiduciary while providing goods or services to the data principal or any other party. Such data must be provided to the data principal in a manner that is well-structured and comprehensible. This ensures easy portability of information between service providers. However, this right can only be availed of when such data processing was done by automated means.<sup>44</sup> This obligation becomes even more important as well as difficult to fall in line with since, it implies that when such notices are sent to children the information must be provided in a manner that the user, in this instance, the children too are able to clearly comprehend the import of such processing.

Lastly, a data principal also has the right to restrict or prevent further disclosure of their personal data by a data fiduciary subject to the condition that the collected data has already served its purpose or the collection of such data has become contrary to the law of the land. An Adjudication Officer<sup>45</sup> must be satisfied that such conditions do exist. This decision of the Adjudicating Officer can be further taken up for review in case of an unsatisfactory decision.<sup>46</sup> Data principals do have the right to withdraw their consent to the processing of their data under Section 11. However, the provision also specifies that in case of data being withdrawn without any valid justification, the consequences of such withdrawal must be borne by the data principal.<sup>47</sup> This imposes an undue restriction on the withdrawal of consent and can disincentivise people from properly making use of their rights and acts as a restraint on free consent.<sup>48</sup>

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<sup>44</sup> *Id.* S. 19.

<sup>45</sup> *See, Id.* S. 62.

<sup>46</sup> *Id.* S. 20.

<sup>47</sup> *Id.* S. 11(6).

<sup>48</sup> Dvara Research, *supra* note 46.

As noted above, the rights of a data principal, even one who is a major and can understand to a greater extent the consequences of the actions, especially when compared to children, itself have huge barriers to cross. The inclusion of vague terms such as “substantially prejudice”<sup>49</sup> and those that impose undue obligations on data principals can to a larger extent adversely affect the usage and relevance on children.

### *B. Special Rights of a Data Principal who is a Minor*

In addition to the rights available to a data principal, certain special provisions apply when the data principal in question is a child under the PDPB. Under its Code of Practice, the Bill prescribes that adequate steps must be taken to verify the age of principals and to accordingly take steps before processing the data of those users who are incapable of giving consent.<sup>50</sup> The Bill also prescribes specific penalties for failing to comply with provisions specifically related to children and the processing of their data.<sup>51</sup>

Chapter IV (Section 16) prescribes special conditions governing the processing of personal and sensitive data of a data principal who is a child. It mandates the processing of data in such a manner so as to ensure the rights and the best interests of the child are protected. Data fiduciaries are instructed to verify a child’s age and receive the consent of the parent or the guardian of the child before such data is processed. In addition, data fiduciaries who operate online services which are focussed on children are classified as “guardian data fiduciaries” and such fiduciaries are expressly prohibited from profiling, tracking or creating advertisements that specifically targeted at children.<sup>52</sup>

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<sup>49</sup> *supra* note 3, S.7(3).

<sup>50</sup> *Id.* S. 50(6)(h).

<sup>51</sup> *Id.* S. 57(2)(d)

<sup>52</sup> *Id.* S.16.

This provision suffers from two limitations. Firstly, it prevents the processing of that information that can cause ‘significant harm’ to children. The definition of harm under Section 3(20) of the Bill includes ten broad situations that are not linked. This vague meaning accorded to harm adversely affects the rights of users.<sup>53</sup> Further, the additional condition of significant harm, broadens the scope for the processing of children’s data. Secondly, The Bill fails to provide an opt out option to children. Such a provision would allow a child to opt out of the conditions consented to by their parents on their behalf on attaining majority.<sup>54</sup> Since, a child on attaining the age of majority has to right to review decisions made on its behalf in accordance with the right to self-determination. The child also has the right to review the terms on the basis of which its data has been processed, and then decide for herself which to retain, which to alter and which to withdraw from.<sup>55</sup>

#### IV. PRIVACY RIGHTS OF CHILDREN UNDER THE GDPR AND THE COPPA

##### A. GDPR

The GDPR is considered to be the toughest privacy law in the world. It was enacted on the 25<sup>th</sup> May, 2018 with the goal of protecting data targeted at or collected from citizens of the European Union. It imposes obligations on organisations that deal with such information to protect the privacy of their users under the threat of the imposition of heavy fines that can run up to tens of millions of euros on those who violate its privacy and security standards.<sup>56</sup> The GDPR contains rules on how a company should process the personal data of data subjects. These rules revolve around the protection of personal data, provision of rights to data subjects and confers on

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<sup>53</sup> Dvara Research, *supra* note 46.

<sup>54</sup> Centre for Internet and Society, *supra* note 38.

<sup>55</sup> Bhatia, *supra* note 39.

<sup>56</sup> *What is GDPR, the EU’s New Data Protection Law*, <https://gdpr.eu/what-is-gdpr/>.

regulators the power to require the submission of compliance reports from organisations.

Chapter 3 of the GDPR lays down the rights of a data subject under the Regulation. These basic rights include; the right to be informed, the right of access, the right to rectification, the right to erasure, the right to restrict processing, the right to data portability, the right to object and rights in relation to automated decision making and profiling.<sup>57</sup> Along with bringing to a uniform level the legal framework regarding data protection in the EU, the GDPR has also for the first time brought in innovative concepts like data portability (which allows users to obtain and reuse their personal data across services), standardised privacy icons and data protection by design and default.<sup>58</sup> In its setting of high standards for citizen and consumer rights, the GDPR brings in significant changes whose effect can be felt beyond the EU.

In addition to providing its member states the freedom to set their own age to deem a person a child for the purposes of privacy law, the EU in its GDPR sets out additional provisions specifically regarding the privacy rights of children in the digital world.

Recital 38<sup>59</sup> recognises that children must be accorded special protection in relation to their personal data since they are more likely to be less aware of the risks, consequences, safeguards and their rights with regard to the processing of their personal data. Such specific protection must be accorded to children in cases where children's data are collected for the purposes of marketing and profiling. Additionally, the GDPR also prescribes that when information society services are offered directly to children, a child's

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<sup>57</sup> *supra* note 3, Chapter 3, arts. 12 – 23.

<sup>58</sup> Jan Philipp Albrecht, *How the GDPR Will Change the World*, 2 EUR. DATA PROT. L. REV. 287, 288 (2016).

<sup>59</sup> *supra* note 40, Recital 38.



consent is valid only when the said child is at least 16 years old, in any other situation the consent of the parent or the guardian of the child is necessary.<sup>60</sup> The GDPR also specifically requires information to be provided to children in a concise, transparent, intelligible and accessible format.<sup>61</sup> It also specially endows upon children under the GDPR the Right to Erasure,<sup>62</sup> in particular in circumstances where the child consented to use of data as a child, not fully aware of the associated risks and later wants to revoke such consent. Although the profiling of children through the use of personal data is not banned completely, parties are encouraged to exercise restraint in this regard. Recital 71 also prohibits the use of automated decision making (including such forms of profiling) on children.<sup>63</sup> Such restrictions are placed on the profiling of children to ensure that they, and in particular, adolescents, are not subjected to targeted marketing strategies which might deprive them of the Right to Information,<sup>64</sup> Right to Development<sup>65</sup> and the Right to Freedom of Thought;<sup>66</sup> by restricting their opportunities to develop their own identities, beliefs and opportunities.<sup>67</sup>

The GDPR has been criticised on a few grounds in regard to the protection it offers children on the internet. First, Article 8 of the GDPR which requires parental consent is only applicable to

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<sup>60</sup> *Id.* art. 8.

<sup>61</sup> *Id.* art. 8 and Recital 58.

<sup>62</sup> *Id.* art. 17 and Recital 65.

<sup>63</sup> *supra* note 40, Recital 71; Information Commissioner's Office, *Consultation: Children and the GDPR guidance*, <https://ico.org.uk/media/about-the-ico/consultations/2172913/children-and-the-gdpr-consultation-guidance-20171221.pdf>.

<sup>64</sup> *supra* note 6, art. 13.

<sup>65</sup> *supra* note 6, art. 6.

<sup>66</sup> *supra* note 6, art. 14.

<sup>67</sup> United Nations Committee on the Rights of the Child, *General comment No. 20 on the Implementation of the Rights of the Child During Adolescence*, [https://tbinternet.ohchr.org/\\_layouts/treatybodyexternal/Download.aspx?symbolno=CRC%2fC%2fGC%2f20&Lang=en](https://tbinternet.ohchr.org/_layouts/treatybodyexternal/Download.aspx?symbolno=CRC%2fC%2fGC%2f20&Lang=en).

information society services (which are often paid services) offered directly to a child, and therefore fails to consider its applicability to free services. Second, the provision fails to clearly delineate the services to which such provisions would apply. Third, it considers reasonable efforts to obtain parental consent as sufficient as opposed to mandating the verified consent of a parent.<sup>68</sup> Despite these drawbacks, the GDPR does provide protection of children's data beyond those provided for under the PDPB. It explicitly recognises that children are a vulnerable group and require special protection in the specifically in the contexts of profiling, targeted advertising and in data processing as a whole. It specifically requires that children be provided information about the manner in which their data is collected and processed, unlike under the PDPB, where such a right can only be inferred. Further, the GDPR also makes provision for the Right to Erasure, one that has not been contemplated under the Indian law. As noted above, the provision of such rights allow children to decide for themselves the manner in which their data can be collected and processed despite their parents providing permission for the same when they were still minors.

### **B. COPPA**

The United States enacted a specific legislative instrument for the protection of personal data of children on the internet, in the form of the Children's Online Privacy Protection Act. It defines a child as a person less than 13 years of age. The COPPA requires operators of website or online services that target children to provide a notice when collecting the personal information of children and they must ensure that parental consent can also be verified. The objective of the COPPA is to place parents in control of what happens to their wards' personal data. It is with the aim to avoid parental consent that many

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<sup>68</sup> Milda Macenaite and Eleni Kosta, *Consent for Processing Children's Personal Data in the EU: Following in the US Footsteps?* 26 INFORMATION AND COMMUNICATIONS TECHNOLOGY LAW, 146, 195 (2017).

services such as Facebook, Instagram, etc. require a user to a minimum of 13 years.<sup>69</sup> The Federal Trade Commission oversees the implementation of COPPA and mandates different verification methods based on the reason for which the information of a child is collected.<sup>70</sup> A novel feature of COPPA is that it mandates parental consent in case of websites or online services that have actual knowledge that their services are used by children. The Act also makes provision for parents to be able to review, delete and prevent further use of their children's data online to ensure proper supervision of its use.<sup>71</sup>

The key requirements of COPPA are notice, parental consent, parental review, limits on the use of game and prizes and security.<sup>72</sup> The Act faces a deficiency also seen under the GDPR, that of requiring only 'reasonable' efforts to obtain a parent's consent. COPPA has been criticised for imposing such high costs on websites that they end up shutting down.<sup>73</sup> Additionally, most other websites do not comply with these requirements since they know that the cost of identifying websites in non-compliance with the law is very high; this is further buoyed by the fact that the cost of non-compliance is very low.<sup>74</sup> One of the biggest differences between the COPPA and the PDPB is the age limit prescribed for children consenting to the

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<sup>69</sup> Holloway, D and Green, L, *The Internet of toys*, 2(4) COMMUNICATION RESEARCH AND PRACTICE, 506-519 (2016).

<sup>70</sup> Federal Trade Commission, *Complying with COPPA: Frequently Asked Questions*, (2015) <https://www.ftc.gov/tips-advice/business-center/guidance/complying-coppa-frequently-asked-questions> .

<sup>71</sup> Milkaite & Lievens, *supra* note 16.

<sup>72</sup> Laurel Jamtgaard, *Symposium on Internet Privacy: Big Bird Meets Big Brother: A Look at the Children's Online Privacy Protection Act*, 16 SANTA CLARA COMPUTER & HIGH TECH. L.J. 385, 388 (2000).

<sup>73</sup> Melanie L. Hersh, *Is COPPA a Cop Out? The Child Online Privacy Protection Act as Proof that Parents, not Government, should be Protecting Children's Interests on the Internet*, 28 URBAN LAW JOURNAL, 1831, 1865-1874 (2001).

<sup>74</sup> *Id.*

use of their own data. The US standard of 13 has since become the de facto standard for parental consent online.<sup>75</sup> While the PDPB requires a person to be older than 18 in order to make their own decisions regarding their data. The COPPA also imposes a higher burden on parents to ensure that they provide consent to those websites that are using their children's data.

## V. CONCLUSION

The rapid digitisation of society requires clear, harmonised and strict measures that can effectively protect the rights of everyone who makes use of and provides data online. It is of absolute importance that when such data is collected by an individual, State or organisation, such an entity should take steps to ensure that they have informed the person of such collection as well as provided information on the future uses of such data. Laws that are enacted to help protect the rights of such individuals must be inclusive and consider all factions of the society. One such faction is that of children. Children form a significant part of the users of the internet, they also form part of the vulnerable group of users of the internet who are capable of giving consent to the collection and use of their data but incapable of understanding the ramifications of such consent. It is therefore of utmost importance that legislations enacted in this respect are capable of protecting this sensitive group of internet users.

The Indian draft PDPB attempts to provide certain special rights to children and to better regulate the processing and use of such data by both the State as well as by private organisations. However, when these steps are compared to the steps taken by the EU and the US for the protection of the personal data of their children, the Indian legislation falls short on certain counts.

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<sup>75</sup> Macenaite, *supra* note 73 at 183.

First, the PDPB prescribes a relatively older age for determining who a child is for the purposes of the privacy law. This undermines the ability of children to decide for themselves what they wish to do with their data. Second, the PDPB only imposes certain restrictions on the use of the personal data of children for processing purposes. It fails to provide a concrete method to prevent the use of children's personal data for targeted marketing which was found to be detrimental to the growth and development of children. Both the EU and the US have specific provisions that clearly state that such personal data of children cannot be used for such purposes. Third, it is suggested that the draft PDPB take cues from the EU and US laws and lay down specific provisions guaranteeing that children will have access to information about the manner in which their data is used. Such data must be provided in a clear and comprehensible manner such that even young adolescents will be able to understand its consequences.

Lastly, the Indian legislation must provide for an explicit right to opt out of the collection and use of any personal data that their parents or legal guardians might have assented to when they were children. Children occupy a unique position in law; they are distinguished from adults due to their vulnerability and perceived lack of understanding of the consequences of their actions. It is important that any legislation that aims to protect their interests must be able to balance their vulnerability with their ability to make decisions for themselves. The draft PDPB has to a large extent failed to appreciate the importance of specifically laying down provisions that exclusively govern the use of personal and sensitive data of children. It is therefore suggested that it attempt to incorporate the above suggestions to the best of its ability to ensure that we have in place a future ready policy that effectively safeguards the rights of its children in a society that is increasingly digitised.

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