Between the lines...

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Highlights

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I. *"Once the arbitrator has become ineligible by operation of law, he cannot nominate another as an arbitrator"*: Supreme Court

The Hon'ble Supreme Court of India in the matter of ***TRF Limited vs. Energo Engineering Projects Ltd.*** (decided on July 3, 2017) dealt with a case in which an arbitrator under the arbitration clause became ineligible to act as an arbitrator owing to the amendment introduced to the Arbitration and Conciliation Act, 1996 (the **"Act"**) in order to ensure the independence and impartiality of arbitrators. The Supreme Court had to decide whether such an arbitrator was also stripped of his powers to nominate an independent and impartial arbitrator.

Facts:

A purchase order was issued by the Respondent to the Appellant in relation to design, manufacturing, supply, etc. of several articles. An arbitration clause was incorporated in the purchase order. When disputes arose between the parties, the Appellant sought reference of the disputes to an arbitrator.

The arbitration clause contained in the purchase order stated:

"33. Resolution of dispute/arbitration

a. *In case any disagreement or dispute arises between the buyer and the seller under or in connection with the PO, both shall make every effort to resolve it amicably by direct informal negotiation.*

b. *If, even after 30 days from the commencement of such informal negotiation, seller and the buyer have not been able to resolve the dispute amicably, either party may require that the dispute be referred for resolution to the formal mechanism of arbitration.*

c. *All disputes which cannot be settled by mutual negotiation shall be referred to and determined by arbitration as per the Arbitration and Conciliation Act, 1996 as amended.*

d. ***Unless otherwise provided, any dispute or difference between the parties in connection with this agreement shall be referred to sole arbitration of the Managing Director of Buyer or his nominee.*** *Venue of arbitration shall be Delhi, and the arbitration shall be conducted in English language.*

e. *The award of the tribunal shall be final and binding on both; buyer and seller."*

The procedure agreed to under the purchase order for appointment of arbitrator was objected to by the Appellant. The Respondent did not agree to the objection citing the binding contractual terms and nominated a former Judge of the Supreme Court of India as a sole arbitrator. This lead to the Appellant filing an application under Section 11 of the Act which provides for, inter alia, appointment of arbitrator by court.

The Appellant relied upon the recent amendments to Section 12 the Act and it was the Appellant's case before the High Court, that the Managing Director could not be appointed as an arbitrator as he was now ineligible to act as arbitrator and as a consequence, the arbitrator has also lost the power to nominate. The Respondent had before the High Court argued that the even if the arbitrator became ineligible, the power of the arbitrator to nominate another person as arbitrator was not abrogated. The High Court ruled in favour of the Respondent and rejected the arguments of the Appellant. Hence, the Appellant filed this special leave petition before the Supreme Court challenging the High Court's judgment.

Issue before the Supreme Court:

The question before the Court was whether the Managing Director, after becoming ineligible by operation of law, could still nominate an arbitrator.

Arguments:

It was argued on behalf of the Appellant that in view of the recent amendment made to the Act, the clause in relation to the appointment of arbitrator became void. It was the case of the Appellant that as the Managing Director himself lost the power to act as arbitrator, his nominees also could not be validly appointed arbitrators, if nominated by the Managing Director. The Appellant side submitted that ineligibility strikes at the root of the power of the arbitrator (Managing Director of the Respondent in this case) to arbitrate or get it arbitrated upon by a nominee.

The Respondent, on the other hand, argued that the recent amendments (Section 12(5) of the Act) only relate to the appointed arbitrator and do not affect his/her authority to appoint an independent and neutral arbitrator.

Observations of the Court:

The apex Court after considering various judgments in detail, observed, *"By our analysis, we are obligated to arrive at the conclusion that once the arbitrator has become ineligible by operation of law, he cannot nominate another as*

an arbitrator. The arbitrator becomes ineligible as per prescription contained in Section 12(5) of the Act. It is inconceivable in law that person who is statutorily ineligible can nominate a person. Needless to say, once the infrastructure collapses, the superstructure is bound to collapse. One cannot have a building without the plinth."

Decision:

The apex Court held that the view of the High Court was not sustainable and consequently the order appointing the arbitrator was set aside. The matter was remanded back to the High Court for fresh consideration of the prayer relating to appointment of an arbitrator.

VA View

The amendment to the Act has made the requirement with regard to appointment of independent and impartial arbitrator very strict. The amended Act specifies certain relationships and if the criteria are satisfied in a particular case, the arbitrator becomes ineligible for appointment.

In this decision of the Supreme Court, a much needed clarity is given. Once the arbitrator named in the agreement becomes disqualified by virtue of the amendment, he cannot nominate another arbitrator. His authority to nominate ceases with him becoming disqualified for appointment as arbitrator.

It may be pertinent to note here that recently the Bombay High Court (Single Judge) in ***DBM Geotechnics & Constructions Pvt. Ltd. vs. Bharat Petroleum Corporation Ltd.*** (decided on May 26, 2017), prior to this judgment of the Supreme Court, had held to the contrary. This decision of the apex Court impliedly overrules the ruling of the Bombay High Court which allowed an ineligible arbitrator to appoint a nominee.

II. Madras High Court rules on oppression of minority shareholders

The Hon'ble Madras High Court delivered its judgement in the case of ***Mr. M. Ethiraj and Ors. vs. Sheetala Credit Holdings Pvt. Ltd. and Ors.*** (decided on July 4, 2017), which involved the question whether an oppressive conduct had been carried out by the majority shareholders of S.V.Global Mill Limited(**"SVG"**), by not electing S. Natarajan, who represented 19% of shareholders, as a director when he was up for re-election. The Single Bench decision delivered by Hon'ble Mr. Justice Rajiv Shakdher held that the action of the controlling stakeholders of not electing Mr. Natarajan, complemented by various other conducts on similar lines, amounted to oppression.

Facts:

The controlling group block including Mr. M. Ethiraj, the co-promoter held 55% of equity shares in SVG, and the other block which comprised of Mr. Natarajan's wife and five companies (in which Mr. Natarajan had controlling stake) held 18.98% of equity shares in SVG. The remaining shares were held by public shareholders.

Mr. M. Ethiraj and Mr. Natarajan were scheduled to retire by rotation and both had offered themselves for reappointment. On September 26, 2014, the Annual General Meeting was convened, which resulted in the re-appointment of Mr. Ethiraj. Mr. Natarajan's re-appointment as director was blocked by the controlling group. Controversy arose on the procedure adopted for the vote for re-election of the directors, as e-voting had been made available, but Mr. Ethiraj and his block voted through the paper ballots in the meeting. Related issues also arose with respect to the conduct in allotting a property valued at INR 300 crores (Indian Rupees three hundred crores) at Boat Club Road, Chennai to Mr. Shanmugam for his residential purpose, who was appointed as the Managing Director, and in relation to investment and loans in companies related to SVG. These instances, as was alleged, indicated mismanagement of the affairs of SVG by the controlling group.

Arguments:

The Appellants (the controlling group including Mr. Ethiraj) contended that the Company Law Board (**"CLB"**) had erroneously determined that there was a practical deadlock in the running of affairs of SVG and it ought to have dismissed the petition. The Appellants further contended that Mr. Natarajan cannot term what had been a 'democratic process' of election of directors as oppression against him. The Appellants further stated that Mr. Natarajan was merely an 'advisor' holding the post of a 'non-executive' director without any significant powers or functions. It was also submitted that Mr. Natarajan and his block, owing to their minority shareholdings, did not reserve an entitlement to appoint a director on the board of SVG by the proportional representation principle. On the issue of procedure adopted for voting, the Appellants contended that the will of the majority shareholders should not be supplanted by intervention of the Courts. On the issue of allotment of property to Mr. Shanmugham, it was pleaded that it had followed the requisite procedures by passing board and shareholders' resolutions.

The Respondents, (Mr. Natarajan's block) contended that the decision had been taken to proceed with electronic voting procedure, and also relied upon the scrutinizer's report, which made it clear that if only the electronic vote had been taken into consideration, then Mr. Natarajan would have been elected as a director. The counsel for the Respondents also alleged mismanagement on part of the controlling group, by their handling of the allocation to Mr. Shanmugam and investment within related parties. The Respondents lastly submitted that the order of CLB ought to be sustained, on the ground that the minority and controlling group could not work anymore, and that 26% of the shareholding was publicly-held among nearly 9000 shareholders, thus resulting in a 'practical deadlock' for any decisions, especially in relation to adoption of special resolutions, to be taken.

Observations of the Court and decision:

The Madras High Court decided the matter on an issue-by-issue basis. It identified the involvement of Mr. Natarajan within SVG by noting that he had been identified as a director in a number of documents and observed that he could not be merely termed as an 'advisor'. The Court further deemed that there existed a deadlock, which could also be described as 'gridlock'.

The Court observed that quasi-partnership principle will be applicable to public listed companies like SVG, as there is no limitation in law that such principle cannot apply to a listed company. The Court further observed that, *“there are several companies, which fulfill the legal regimen of a public listed company, but are otherwise controlled in large measure by a group of shareholders, who run the company, like a family-owned company”.*

The judgement then proceeds on the point of legality of allowing postal ballots despite the decision being taken to provide e-voting. While it is recognized that the right to vote is an inalienable right that a company shareholder has, restrictions may be imposed in the manner it is exercised, the Court noted. Once the notice had been given on following a particular process, namely e-voting, within the meeting, or even making it available as an option, the procedure should be followed uniformly and should not be supplanted by any other means. Thus, as was noted by the Court, the controlling group was wrong in casting ballot contrary to the procedure provided. On the allegations of mismanagement regarding allocation of property and investments, the Court held that sufficient disclosures with respect to the nature of the property actually being allotted were not made and the investment in related companies was identified as a contributing factor to determine whether there was oppression of the minority.

Lastly, keeping all the above points in consideration, and the fact that such a question is to be determined not only on the basis of legality, but as much as on principles of equity, it was held that an act of oppression had been carried out. The appeal was partly allowed, wherein the obligation to purchase shares was merely imposed upon the controlling shareholders and not SVG, unlike the CLB order. It further scheduled a hearing in National Company Law Tribunal, Chennai Bench on the matter of valuation of shares for July 14, 2017.

VA View

The above judgment marks another instance of issues which plague corporate governance despite the humongous reforms carried out over the past few years since the introduction of the Companies Act, 2013.

Despite a number of provisions being carved out for protection of minority shareholders over the period of time, majority shareholders still find ways and means to impose their decision on the minority. But interestingly, the opportunity for the majority to buttress their say in the present matter arose out of an advantage which was offered due to ambiguity surrounding the procedure and nature of voting to be followed. The Court also, quite importantly, noted that Mr. Natarajan of the minority holding group could not be merely termed as an ‘advisor’. For this, the Court looked at several important factors including reference to several documents where he was identified as a promoter and director.

III. No liability for non-payment of declared dividend to be imputed upon the independent directors once duties discharged satisfactorily

The Securities and Exchange Board of India (**"SEBI"**) in its order in respect of ***Mr. S. Rajagopal and Mr. V. K. Ramani, Independent Directors of Zylog Systems Limited,*** dated June 20, 2017, observed that the independent directors of a company will not be liable for the failure of such company to pay out the declared dividends if it is seen that they had fulfilled their duties as independent directors satisfactorily.

Facts and arguments:

Zylog Systems Limited (**"Zylog"**) had declared dividend to its shareholders. This dividend was not disbursed by Zylog, and SEBI acting upon a multitude of complaints by the disgruntled investors sent a letter to Zylog seeking information regarding declaration and payment of dividend under the Companies Act, 1956 (the **"Act"**) and reasons for default with respect to the same. Zylog replied to the above letter pleading liquidity crunch and furnished the list of directors of the company at the time of declaration. As a result, SEBI issued show-cause notices to all directors, including to Mr. S. Rajagopal and Mr. V.K. Ramani who served as the independent directors at the time when the dividend was declared. The show-cause notices were issued for violation of S. 205(1A) and S.207 of the Act, which obligates directors of a company to deposit the amount of dividend declared into a separate bank account within 5 (five) days of the declaration, and provides penalty for failure to distribute dividends within 30 (thirty) days respectively.

In response to the show-cause notice, both the independent directors pleaded that they were not involved in the day-to-day functioning of Zylog. They were made aware about the default in payment of dividend at various instances in November, 2012. Mr. Rajagopal was also the Chairperson of the Audit Committee, which raised concerns and reservations regarding the non-payment of dividends, and sought to bring the concern about the same to the notice of the board of directors and ensure that the management complies with what was a statutory obligation. In the board meeting held on November 14, 2012, the matter regarding the non-payment of the dividends had been bought up before the board and reservations had been raised about the same. The board took note of the reservation of the Audit Committee and Mr. Rajagopal regarding the default. Eventually, Mr. Rajagopal tendered his resignation as a director on November 20, 2012 and Mr. Ramani followed suit on January 2, 2013. In the light of the minutes of these meetings, and copy of minutes as an evidence of the same, the independent directors pleaded that they had acted promptly and diligently, and hence should not be held liable for the default.

Observations of SEBI and decision:

SEBI held that the duties of the independent director include guiding the management, working in the best interests of the company, protecting the minority shareholders and ensuring compliance of the company to statutory duties or obligations. In the present matter, SEBI noticed that the noticees had strongly expressed reservations against the

non-payment of dividends and attempted to convince the management to ensure that the payment is made as it was a statutory obligation. Once the advice was not heeded to, they submitted their resignations. Since as independent directors they were not involved in the day-to-day functioning of the company and that they discharged their own duties satisfactorily, the liability could not be imputed upon them. Hence, no directions were passed against Mr. Rajagopal and Mr. Ramani and the show-cause notice was accordingly disposed of.

VA View

The present order helps significantly in clarification of the duties of independent directors, and the resulting discharge of burden on fulfillment of such duties. Imputing liability upon the independent directors when they have already acted as required would have resulted in stretching the onus of liability to unjust lengths. The order ensures that once an independent director has completed his or her duties, and attempted to correct the course of the company to the best of his or her abilities, liability should not be imposed upon such an independent director.

IV. Standard Operating Procedure for processing of Foreign Direct Investment proposals released

The Department of Economic Affairs, Ministry of Finance came out with Office Memorandum dated June 5, 2017 giving salient features of the new regime and had mentioned, *"a Standard Operating Procedure (SOP) with detailed guidelines shall be developed and laid down by the DIPP in consultation with Administrative Ministries/Departments/sector regulators so as to guide the Administrative Ministries/Departments for processing of the FDI proposals and ensure a consistency of treatment and uniformity of approach across sectors."* It was further mentioned that the applications pending with the Foreign Investment Promotion Board (**"FIPB"**) portal as on the date of abolition of FIPB were to be transferred to the respective ministry/department by the Department of Industrial Policy and Promotion (**"DIPP"**).

DIPP, Ministry of Commerce and Industry, came out with the Standard Operating Procedure (**"SOP"**) for processing Foreign Direct Investment (**"FDI"**) proposals on June 29, 2017. Needless to say, this will be applicable in case of FDI in sectors under the government approval route, and not to the sectors under the automatic route.

Key takeaways from SOP:

- **Online filing:**

The FDI proposals are to be filed on the new Foreign Investment Facilitation Portal. As now the concerned ministry/department is responsible for giving approval, after the online filing, DIPP will e-transfer the proposal to

such concerned ministry/department within 2 (two) days. The applicant is not required to submit physical copy of application if the same is digitally signed. If not digitally signed, DIPP will communicate regarding submission of physical copy by the applicant and applicant is required to submit the signed physical copy of the application within 5 (five) days of intimation from DIPP.

- **Competent authorities:**

As now the concerned sectoral ministry/department will take charge of proposals, competent authorities for different sectors are mentioned, like, Ministry of Mines will be the competent authority for considering proposals pertaining to the mining sector, Ministry of Information & Broadcasting for proposals in the broadcasting and print media sector, etc.

- **Procedure:**

  – Competent authorities cannot designate an inter-ministerial body in respective ministry/department for granting approvals. It is mentioned that new regime for foreign investment needs to be simpler in execution and expeditious in disposal.

  – The proposal will be circulated by the DIPP to the Reserve Bank of India for comments from FEMA perspective. Foreign investment proposals in sectors requiring security clearance (proposals requiring security clearance are specified in SOP) would additionally be referred to the Ministry of Home Affairs for comments. All proposals will be forwarded to Ministry of External Affairs and Department of Revenue for information and they can give their comments if necessary to the concerned ministry/department.

  – In case of proposals involving total foreign equity inflow of more than INR 50 billion(Indian Rupees Fifty billion), concerned ministry/department is required to send the same to the Cabinet Committee on Economic Affairs for consideration.

  – In case concerned ministry/department decides to reject the proposal or proposes to put conditions over and above the conditions provided under the FDI policy or sectoral laws/regulations, concurrence of DIPP is compulsory.

- **Time limits:**

Time limits are provided for each stage of the procedure under the SOP. An estimated time period for approval of the proposal can be said to range between 8 (eight)-12 (twelve) weeks. However, this excludes the time taken by applicants in removing deficiencies in the proposals/supplying additional information as may be required by the concerned ministry/department.

VA View

We had reported in March, 2017 edition that the FIPB was abolished and new framework was expected soon and that in a significant change to the practice of approving FDI proposals, regulators or ministries for a particular sector were all set to take charge of approving the FDI proposals for such sector.

The new framework has been released and the concerned ministries/departments are now given charge of the FDI proposals pertaining to their sector. It is hoped that the new regime will achieve its objective of an efficient time-bound approval regime for sectors under the government route and it is expected that this will boost the foreign investment sentiment.

However, one concern as was flagged by us remains. The lack of experience of the ministry and departments in handling of FDI proposals may cause problems. However, to certain extent, this concern may be said to have been addressed by the provision made in SOP that DIPP concurrence is a must in cases where concerned ministry/department decides to reject a proposal or proposes to put conditions over and above the conditions provided under the FDI policy or sectoral laws/regulations.

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