BRIEF CASE ● M J ANTONY

A weekly selection of key court orders

Illegal extension has no insurance cover

The demolition of an illegal extension of a building by civic authorities would not be covered by a general insurance policy, the Supreme Court has ruled in its judgment in the case, New India Assurance Co vs Rajeshwar. The appeal of the insurance company was against an order of the Jammu & Kashmir Consumer Commission, which awarded a compensation of ₹1.728 million. It was upheld by the high court. In this case, the owner built a projection to the road. The municipal committee of Jammu found that it was against the master plan. It advertised a project removal of the projections, platforms and encroachments not in conformity with the master plan. When the projection, in this case, was demolished, the owner filed a suit in the civil court and moved the consumer commission. While the suit was pending, the commission and the high court awarded compensation. The insurer appealed to the Supreme Court arguing that any removal of construction by "order of the government or any lawful authority" was excluded in the policy. The court accepted the contention and quashed the orders of the high court and the commission. It allowed the suit to continue stating that it was a different cause of action.

Burden of proof on customs

The Supreme Court last week declared that if the customs authorities allege an importer had under-invoiced the value of goods, they have to support it by evidence of prices of contemporaneous imports of like goods. While dismissing the appeal case, Commissioner of Central Excise vs Sanjivani Non-Ferrous Trading Co, the court stated that the revenue authorities did not do any such exercise in this case. The authorities rejected the price declared in the Bill of Entry. The judgment explained that under Section 14 of the Customs Act, the invoice price can be disputed. "However, it is for the department to prove that the invoice price is incorrect. When there is no evidence of contemporaneous imports at a higher price, the invoice price is liable to be accepted," the court said. The firm, in this case, imported aluminium scrap and submitted 843 bills of entry and invoices. The declared value was not accepted by the assessing officer who found it to be less. Accordingly, the declared value was rejected and reassessment was done by increasing the assessable value. This led to long litigation in which the revenue authorities lost.

Arbitrator can be employee of party

"The fact that an arbitrator is an employee of one of the parties is not by itself a ground to raise a presumption of bias or lack of independence on his part," the Supreme Court stated in its judgment in the case, SP Singla Constructions Ltd vs State Of Himachal Pradesh. Arbitration agreements in government contracts providing that an employee of the department or a higher official unconnected with the work or the contract will be the arbitrator are neither void nor unenforceable. In this case, a bridge project on the Beas was given to a contractor, but when disputes arose, a superintending engineer was appointed as arbitrator, according to the General Conditions of Contract. The contractor did not participate in the proceedings. Therefore, the proceedings were terminated. The contractor appealed to the Supreme Court. It rejected the argument of bias and the exclusion of employees under the amended Arbitration and Conciliation Act in 2015. The court revived the arbitration and asked the contractor to join it.

Consumer disputes outside arbitration

The Supreme Court reiterated last week that consumer disputes cannot be referred to arbitration. In this review petition, Emaar MGF Land Limited vs Aftab, the National Consumer Commission had held that consumer disputes are non-arbitrable. The commission had also dismissed another petition under the Arbitration and Conciliation Act. In this case, a person wanted to buy a villa from the builder of an integrated township in Mohali, Punjab. Disputes arose and the matter was taken to the state consumer commission. The builder relied on the arbitration clause in the contract. However, the commission rejected the argument stating that despite the clause, the dispute cannot be referred to arbitration. The builder appealed to the Supreme Court a few months ago. It upheld the view of the state commission. The builder filed a review petition and relied on the 2015 amendment to the Arbitration Act. According to it, if there is an arbitration clause, the dispute must necessarily go to arbitration. The Supreme Court rejected the contention. Dismissing the review petition, the judgment emphasised that the amendment to Section 8 cannot be given "an expansive meaning so as to inundate the entire regime of special legislation where such disputes were held to be not arbitrable. Something which legislation never intended cannot be accepted as a side-wind to override the settled law."

NCLT, not HC, to deal with IBC case

The Supreme Court set aside the ruling of the Rajasthan High Court in a case involving the Insolvency and Bankruptcy Code (IBC) and the Companies Act and allowed the National Company Law Tribunal (NCLT) to proceed with the insolvency proceedings. In this case, Jaipur Metals & Electricals Employees Organisation vs Jaipur Metals, the high court had refused to transfer the winding up proceedings before it to the NCLT. It had also set aside the NCLT order by which a financial creditor's petition under the IBC was admitted. The case has a chequered history. The company was declared a non-performing asset in 1997 and ever since it was caught in litigation involving the Sick Industries Act and other laws. The Alchemist Asset Reconstruction Company had acquired substantially all financial debts of the company. The state government tried to revive the sick company without success. Meanwhile, the code was implemented and the Alchode must run their entire course," the judgment said.

Losing leg is 100 per cent disability

Losing a leg amounts to 100 per cent functional disability in the case of a driver of a vehicle and the insurance firm must compensate the victim according to that computation, the Supreme Court stated in the case, Arun Kumar vs Ranvir Singh. The commissioner under the Employees Compensation Act had granted only ₹387,000, including the penalty. On appeal, the insurance company argued that the benefit of an amendment to the Motor Vehicles Act could not be extended to the victim as the accident occurred prior to the amendment. The court rejected the argument and raised the compensation by ₹1 million.

Fixing rules for medical devices

The absence of compensation provisions in the Drugs & Cosmetics Act puts the spotlight on the gaps in the regulatory regime

SHREEJA SEN

The recent developments in the Johnson and Johnson (J&J) hip implant case have highlighted the gaps in the regulatory regime around medical devices in India. On November 29, the health ministry approved of a formula to determine the compensation to be paid by J&J to the patients who received "faulty articular surface replacement (ASR) hip implants manufactured by DePuy International, UK". This led to the company approaching the Delhi High Court over the applicability of such an order of the government, in the absence of specific statutory norms to the effect. This has thrown up several legal issues, including the scope of the governing law over medical devices, the Drugs and Cosmetics Act, 1940 (DCA).

Regulating medical devices

At present, medical devices are classified as 'drugs' for the purpose of their regulation. "Devices still have to be notified as drugs before they fall within the ambit of the rules (under the DCA). This is because the rules are framed under the DCA, which regulates drugs, necessitating this legal fiction," said Dhvani Mehta, senior resident fellow at Vidhi Centre for Legal Policy.

So, whether or not a product is regulated does not depend on its characteristics, as much as it does on whether it has been notified as a drug by the Central Government, she adds.

Concerns with the Act

The law itself is a 1940-legislation with amendments over the years, the most recent being in 2010. The rules underneath the law are updated regularly, with the Medical Devices Rules, 2017, being the latest. This can lead to several concerns, according to experts.

"The rules cannot of themselves impose civil or criminal penalties for the manufacture and sale of defective medical devices. These can only be imposed under the DCA," Mehta said.

Experts noted that keeping up with changes in technological advancements through rules, executive orders, or guidelines was a reactive, haphazard, and incoherent manner of functioning. "If there were a strong primary legal framework, we would not have to resort to regulation in this fashion," Mehta added.

While experts welcomed the Medical Devices Rules, 2017, for setting out a separate regulatory measure, there is still need for an overarching framework specific to the medical devices sector. "Need of the hour is a separate legislation for medical devices that has not seen the light of day so far," said Milind Antani, lead, pharma and health care practice, Nishith Desai Associates.

Absence of compensation provisions

The recent case filed in by J&J in the Delhi High Court is reflective of the fact that the DCA falls short in providing a mechanism for compensating patients in case of faulty devices. "Provisions relating to compensation to the users of faulty devices have remained unaddressed in the present regulatory regime," said Rajdutt Shekhar Singh, partner, Singh & Associates. Mehta called this a weakness in the DCA, given that there is no provision for imposing "civil penalties or awarding compensation for substandard drugs or devices". In fact, in a tweet, intellectual property expert Shamnad Basheer called it "sheer naivete" to rely on a report of a toothless government committee.

Role of the CDSCO

The prime actor in this regulatory regime is the Central Drugs Standard Control Organisation (CDSCO), which works as the Central Licensing Authority. Practitioners maintained that the CDSCO was the authority acting under the DCA and its rules. "As with drugs, the regulation of medical devices is... split between the CDSCO and the state drug licensing authorities," said Darren Punnen, a member of the pharma and health care practice at Nishith Desai Associates.

However, Mehta pointed out that "there is no explicit mention of the CDSCO in the DCA". A 2016 public interest litigation filed in the Supreme Court highlighted "the fact that the Ministry of Health and Family Welfare was unable to point to the law or executive order under which the CDSCO was created". In fact, the 59th Report of the Parliamentary Standing Committee on Health and Family Welfare raised concerns about the CDSCO's financial and technical capacity, as well as its independence and integrity, Mehta added.

Next steps

A primary legislation specific to the regulation of medical devices is needed, said experts. "An independent legislation governing medical devices would be ideal for both the industry as well as the patients, as the legal requirements could be better tailored to suit the sector, as opposed to being couched within the DCA," Antani said. That would also assist the regulator to control quality and enforce better, he added.

Singh noted that "invasive devices (which penetrate inside the body) bearing high risks ought to be brought under the regulatory framework". Post-market surveillance of medical devices would play a significant role in addressing the issue of faulty devices. "Further, the CDSCO is required to evaluate international recalls of medical devices on a real-time basis to avoid such mishaps," he added.

ISSUES CONCERNING MEDICAL DEVICES

- Lack of dedicated law
- Excessive reliance on secondary legislation or rules
- No compensation provisions
- Absence of a sound regulator

PROPOSED ARBITRATION COUNCIL

Experts wary of government influence

AASHISH ARYAN

In August, when the Lok Sabha passed the Arbitration and Conciliation Bill (Amendment) Bill, 2018, many experts termed it retrograde and detrimental for the purposes of arbitration and conciliation. The Bill is likely to be introduced in the Rajya Sabha during the ongoing winter session. Experts are again apprehensive of what they call gaping holes in the Bill and have called for certain amendments before it becomes a law.

Among other provisions, the Bill seeks to establish an independent body called the Arbitration Council of India. Though envisaged as an independent body, the council will only have individuals nominated by the Centre, and secretaries from the department of legal affairs and the department of expenditure as ex-officio members. Such an overarching presence of the government in the council is undesirable and uncalled for, experts said.

"The Arbitration Council of India as currently envisaged is akin to a regulator. This is unnecessary and undesirable. There is not a single other arbitration-friendly jurisdiction in the world that has a similar setup," noted Vikas Mahendra, partner at Keystone Partners. A high-level committee set up to review the institutionalisation of arbitration mechanism, headed by Justice B N Srikrishna, suggested that the council should consist of individuals nominated by the Chief Justice of India, the Centre, and a reputed overseas practitioner.

The government, however, took a completely different stand, which is not a prevalent practice, said Ajay Thomas, vice-chairman of the ICC India Arbitration Group. "Ideally, the government should have the same influence on the Arbitration Council of India as the other stakeholders such as the end-users, the bar and the Bench," Thomas said.

Experts pointed out that the government is the biggest litigant. "Any licensing of arbitration institutions or arbitrators by the government gives the appearance of bias and hits at the very root of independence and impartiality — the cornerstones of arbitration," said Mahendra.

Apart from the structure of the arbitration council, the confidentiality clause during the arbitral proceedings is a bone of contention among experts. The Bill proposes maintaining confidentiality during arbitral proceedings. This applies to arbitration proceedings, the arbitrator, arbitral institution and all the parties involved.

Experts said a blanket order of confidentiality would force parties to choose between violating the Arbitration Act and regulatory requirements. The Bill also steers clear of the much wider exceptions recommended by the Justice Srikrishna Committee.

"Typically, such exceptions should be expanded to allow disclosure where it is necessary for protecting or enforcing legal rights of a party, where a party is ordered to disclose details by a competent authority or where a party requires advice from its professional or other advisors," noted Ashish Kabra, senior expert, international litigation and dispute resolution at Nishith Desai Associates.

The 12-month deadline suggested by the government in the Bill is perhaps the only silver lining and step towards making India a global arbitration hub, experts said. The Bill seeks to introduce Section 29 (A), which prescribes a 12-month deadline from the date on which the tribunal receives a notice of appointment for making the award. The Bill provides for a further extension of six months of the deadline, after a mutual agreement between the parties, or otherwise through a court order.

"Statistics emanating from leading international arbitral institutions reveal that it takes around 12-18 months for the completion of arbitration. If there were to be complex issues of fact and law necessitating lengthy evidence, a slightly longer timeline would be in order," Thomas said.

Though the timelines have largely ensured that arbitrations were completed in an efficient and time-bound manner, removing international commercial arbitrations from deadline limitations could prove counterproductive, Kabra said. "Foreign investors and other foreign players would have to be conscious before keeping their arbitrations in India, as they would no longer have an assurance that the arbitration would be completed within a time frame," he said.

ILLUSTRATION: BINAY SINHA

Tax uncertainty continues on LLP conversions

PRASHANT KAPOOR & KANIKA GOEL

Recently, the Mumbai Bench of the Income Tax Appellate Tribunal (Tribunal) ruled that conversion of a company into an LLP (limited liability partnership) firm would be construed as a transfer and thus, be chargeable to tax on the pretext that specific tax neutrality conditions provided in the Income Tax Act, 1961 (IT Act), are not complied with. Though the tribunal went on to compute the capital gains tax as Nil, it would be worthwhile to discuss the background of this issue to understand the impact of this judgement.

The LLP Act provides an enabling provision for conversion of a company into an LLP. Since LLPs offer a more flexible mode of carrying on business, along with the fact that they are not liable to a dividend distribution tax as applicable to companies, conversion was considered actively by existing businesses operating as companies. The Finance Act, 2010, introduced Section 47(xiiib) under the IT Act, which provided for compliance with certain conditions to enable tax-neutral conversion of a company into an LLP. These key conditions revolve around the turnover size and asset size prior to conversion, as also the continued majority ownership of existing shareholders and preservation of the existing reserves.

For companies which were not in compliance with the above conditions, a position on non-chargeability of tax was considered, placing reliance on an earlier judgement of the Bombay High Court (HC). The Bombay HC had ruled under the provisions of Part IX of the Companies Act that conversion of a firm into a company does not involve the existence of a party and a counterparty to constitute a transfer and further there is no consideration involved.

However, the Mumbai tribunal has taken a contrary view and distinguished the Bombay HC case on the basis that Part IX of the Companies Act referred to a statutory vesting of the assets and liabilities, whereas the LLP Act (Third Schedule) specifically states that on conversion, the assets and liabilities will be transferred to the LLP. The tribunal also relied on the memorandum explaining the Finance Act, 2010, which specifically laid out that conversion is a transfer, and hence, specific conditions were being introduced to exempt such transfer under Section 47 (xiiib).

However, it is interesting to note that though the tribunal has held the conversion to be taxable, no capital gains arose on actual computation since the consideration received on conversion was considered to be equivalent to the book value of assets.

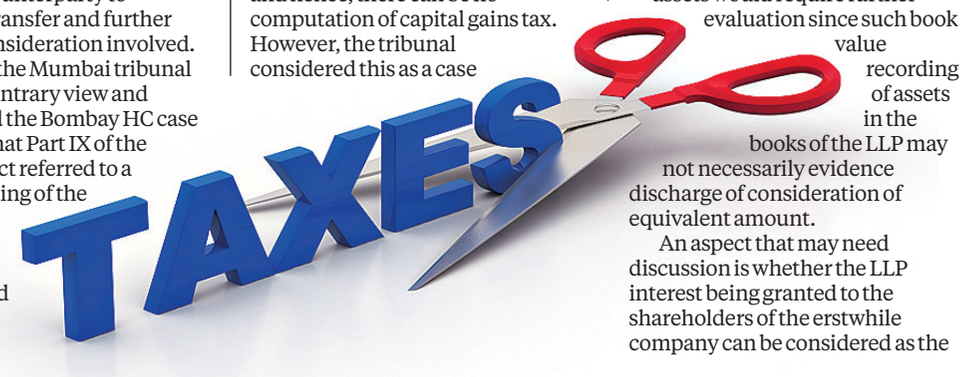
Another argument put forth by the taxpayer was that the cost of acquisition of the undertaking of the company was not determinable and hence, there can be no computation of capital gains tax. However, the tribunal considered this as a case of succession and held that the cost of acquisition would be the cost to the previous owner i.e. the company. It is interesting to note that there may be a basic anomaly in this observation since capital gains are computed for the company and not the LLP.

It would be meritorious to debate on a few issues that arise out of the tribunal's decision. While distinguishing the Bombay HC judgement, the tribunal has not dealt with the fact that a transfer requires the existence of both the buyer and the seller at the time of the transfer, which may be ambiguous in the case of conversion of the company into an LLP. In case the conversion is held to be a transfer, the tribunal's summary observation that the consideration would be the 'book value' of the assets would require further evaluation since such book value recording of assets in the books of the LLP may not necessarily evidence discharge of consideration of equivalent amount.

An aspect that may need discussion is whether the LLP interest being granted to the shareholders of the erstwhile company can be considered as the consideration for the transfer (a similar theory was propounded by the Delhi HC in a decision where consideration for slump sale was discharged partly to the shareholders of the seller company). Whether Section 50D could have any application to this subject and could fair market value of the assets transferred be deemed to be the consideration for the transfer.

The taxability of the shareholders of the company undergoing conversion can be another area of tax uncertainty. It can be debated whether the extinguishment of shares and receipt of LLP interest in return can be brought to tax separately in the hands of the shareholders even though Section 47A of the IT Act talks only about taxing either the company or the shareholders. Transfer pricing provisions could also interplay in this regard to determine the arm's length price in case of non-resident shareholders.

This is an important decision and is likely to have a far reaching impact. However, certain issues would require detailed evaluation before certainty can be obtained on tax treatment of LLP conversions.



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