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Vodafone Investment Treaty Arbitration Award: Implications of Vodafone Arbitration Award on the Rights of Investors to Claim Under Treaties

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INTRODUCTION

On September 25, 2020, the international arbitral tribunal constituted in the case of Vodafone International Holdings BV v. The Republic of India (Vodafone case) held that India had violated the 'fair and equitable treatment' (Vodafone award) guaranteed to VIHBV under the 1995 Bilateral Investment Promotion and Protection Agreement (BIPA) between the Republic of India and the Kingdom of Netherlands (India – Netherlands BIT).

This week, we will provide an analysis of the impact of the Vodafone award on foreign investors through a series of articles. The complete award is not available in public domain. However, an excerpt has been made available. The Vodafone award stimulates critical issues for foreign investors investing in India. The following article provides a background to the dispute and examines the prominent issues arising out of the Vodafone award. For a detailed analysis of various investment treaty arbitration cases involving India in 2019 and bilateral investment treaties signed by India, please see **here**.

BACKGROUND

The Transaction

In 2007, Hutchinson Telecommunications International Limited, a Hong Kong entity (HTIL) sold its stake in another Cayman entity, which indirectly through a string of subsidiaries, held shares of Hutchinson Essar Limited, an Indian company (HEL) to Vodafone International Holdings B.V., a Netherlands entity (VIHBV) for a consideration of USD 11.1 Billion. HTIL earned capital gains on the sale. The Indian revenue authorities considered that acquisition of stake in HEL by VIHBV was liable for tax deduction at source under Section 195 of the Income Tax Act, 1961. Since VIHBV failed to withhold Indian taxes on payments made to the selling Hutch entity, a demand was raised on VIHBV under Section 201(1)(1A) / 220(2) for non-deduction of tax.

The Indian Supreme Court Decision

On January 20, 2012, the Supreme Court of India[1] discharged VIHBV of the tax liability imposed on it by the Income Tax Department of the Plaintiff. The Supreme Court held that sale of share in question to Vodafone did not amount to transfer of a capital asset within the meaning of Section 2(14) of the Income Tax Act. The Apex Court not only quashed the demand of INR 120 billion by way of capital gains tax but also directed refund of INR 25 billion deposited by the Vodafone in terms of the interim order dated November 26, 2010 along with interest at 4% p.a. within two months.

The Indian Retrospective Tax Legislation

Post the above judgment, the Indian Parliament passed the Finance Act 2012, which provided inter alia for the insertion of two explanations in Section 9(1)(i) of the Income Tax Act (2012 Amendment). The first explanation clarified the meaning of the term "through", stating that "For the removal of doubts, it is hereby clarified that the expression 'through' shall mean and include and shall be deemed to have always meant and included 'by means of', 'in accordance of' or 'by reason of'." The second explanation clarified that "an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India".

The 2012 Amendment also clarified that the term "transfer" includes and shall be deemed to have always included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily, by way of an agreement (whether entered into in India or outside India) or otherwise, notwithstanding that such transfer of rights had been characterized as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India.

The Arbitration Claim under India-Netherlands BIT

Aggrieved by the imposition of tax by way of retrospective amendment of the Indian tax legislation, VIHBV invoked arbitration under the India – Netherlands BIT through a notice of dispute dated April 17, 2012. On February 20, 2014 India stated that "disputes relating wholly or mainly to taxation are excluded from the scope of the India – Netherlands BIT. On April 17, 2014, VIHBV issued a notice of arbitration to India as required under the India-Netherlands BIT.

Parallel Proceedings

On January 24, 2017, Vodafone Group Plc., a United Kingdom entity and the parent company of VIHBV, initiated arbitration against India under the India-United Kingdom BIT, challenging the retrospective amendment by India of its tax legislations.

Government of India (GOI) filed a suit before its national courts seeking anti-arbitration injunction to restrain Vodafone Plc from continuing arbitration proceedings under the India-UK BIT. On August 22, 2017, the Court passed an *ex-parte* interim order restraining the Defendants from initiating or continuing arbitration proceedings under the India-UK BIT. Please see our coverage on the aforesaid decision here**.** However, in its final judgment on May 7, 2018, the Delhi High Court vacated the stay and dismissed the suit against Union of India. Please see our coverage on the aforesaid decisions **here**.

Vodafone Award

On September 25, 2020, an international arbitral tribunal comprising L.Y. Fortier, R. Oreamuno Blanco and F. Berman passed an award in favour of VIHBV, reportedly for violation of the fair and equitable treatment standard under the India – Netherlands BIT. The arbitral tribunal directed India to reimburse legal costs of approximately INR 850 million to Vodafone. The complete award is not available in public domain. The excerpt available in public domain is reproduced below:

> *"(3) The Respondent's conduct in respect of the imposition of the Claimant of an asserted liability to tax notwithstanding the Supreme Court Judgement is in breach of the guarantee of fair and equitable treatment laid down in Article 4 (1) of the Agreement, as is the imposition of interest on the sums in question and the imposition of penalties for non-payment of the sums in question.*
>
> *(4) The finding of breach in paragraph (2) entails the obligation on the Respondent to cease the conduct in question, any failure to comply with which will engage its international responsibility.*
>
> *(7) The Respondent will reimburse to the Claimant the sum of £4,327,294.50 or its equivalent is US Dollars, being 60% of the Claimant's costs for legal representation and assistance, and €3,000 or its equivalent in US dollars, being 50% of the fees paid by the Claimant to the appointing authority."*

IMPLICATIONS OF THE AWARD

A reminder that Foreign Investors have access to remedies under International Law

An international investment typically involves a commercial agreement between the foreign investor and the host State (Investment Contract). Investment contracts provide for dispute resolution either before domestic courts or administrative tribunals, or through international arbitration.

In addition, a foreign investor can examine if the country of its nationality (Home Country) has entered into an international investment agreement (IIA) with the State within whose territory investment is made (Host State). IIAs can be in the form of a bilateral investment treaty (BIT), a free trade agreement with an investment chapter (FTA), or a regional cooperation and economic partnership agreement with guarantee for investment protection. Additionally, a foreign investor must also check if the Home Country and the Host State are members of a multilateral convention such as the Convention for Settlement of Investment Disputes (Washington Convention, 1965). IIAs commonly provide for dispute resolution through international arbitration between a covered investor and the Host State.

In the event of a dispute, therefore, investors may find that the relevant facts fit both under an investment contract or an IIA, with distinct dispute resolution clauses. We have regularly conducted legal analyses for investors to ascertain the correct forum for initiation of disputes, in cases involving overlapping claims under investment contracts and IIAs.

The Vodafone case did not arise out of an investment contract between VIHBV and the GOI. Having emanated from retrospective tax legislation by India, it was brought under an IIA. While Vodafone could have exercised a right to challenge the constitutionality of the amendment before the Supreme

Court of India, it chose to initiate arbitration under the India – Netherlands BIT.

Foreign investors investing in India need to be mindful of any IIAs that have been signed by their home countries - that may provide access to them against adverse Indian measures under international law. The Vodafone award reinforces the availability of an effective mechanism to foreign investors under IIAs.

We have advised foreign investors on several pre-initiation issues such as funding arrangements, pros and cons of arbitration on investors' relationship with India under particular sectors, risk insurance, time and costs benefit analysis, alternate remedies to safeguard foreign investment, in-depth analysis of commercial agreements and treaties to find overlaps and best mechanisms to pursue remedies. These issues require thorough evaluation before initiating arbitration under an IIA.

Termination of BITs by India – Do Investors continue to have a right to initiate disputes?

As per the Indian Department of Economic Affairs website, 69 out of 84 BITs have been shown to be terminated on various dates since 2016.[2] In light of such terminations, we are often asked if foreign investors continue to have a right to initiate disputes under the terminated BITs. This depends on the language of the BIT.

BITs remain in force for the duration mentioned therein – generally ranging from 10 to 15 years. The procedure for termination of a treaty prior to expiry of its original term is provided in the treaty. Upon expiry of the original term, most BITs are automatically extended. A Contracting Party desiring to terminate the extended BIT can do so by expressing its intention to terminate, often through a written notice to the other Contracting Party. The BIT then terminates within a fixed term provided in the treaty.

Majority BITs extend treaty protections to an investment for a fixed period beyond termination. This is evident from the latter portion of the above clause. The shortest fixed survival period is, for instance, 5 years and the longest is 25 years. For a foreign investor to take benefit of such extensions, it is essential to analyse the conditions under which the BIT provides such protection to investment even after termination. Hence, foreign investors could continue to have a right to initiate disputes despite denunciation of BITs by India.

For instance, Article 16 of the India – Netherlands BIT titled '*Duration and Termination'* provides:

> *"1. This agreement shall remain in force for a period of ten years. Unless notice of termination has been given by either Contracting Party at least six months before the date of the expiry of its validity, the present Agreement shall be deemed to have been extended for period of ten years at a time, each Contracting Party reserving the right to terminate the Agreement upon notice of at least six months before the date of expiry of the current period of validity. In respect of investments made before the date of the termination of the present Agreement the foregoing Articles shall continue to be effective for a further period of fifteen years from that date*."

The India-Netherlands BIT was signed on November 6, 1995; and came into force on December 5, 1996. The date of termination of the India – Netherlands BIT as per the Indian Department of

Economic Affairs website is September 22, 2016. On the basis of Article 16 above, investments made in India prior to September 22, 2016 would be protected for fifteen years from the date of termination, under the India – Netherlands BIT.

In January 2020, India proposed the enactment of a national legislation for investment protection and initiation of investor-State disputes.[3] While this is at a nascent stage and no information is available in public, investors must keep an eye on the Indian legal framework which could witness enactment of this legislation in 2021/2022.[4]

Impact on existing litigation and arbitration proceedings involving retrospective tax legislation

The Vodafone award could influence potential claims from foreign investors who have been brought under the tax net by virtue of the retrospective tax legislation. This could be best effectuated via a claim under IIA. Litigation in Indian national courts is already pending for several years, and may not provide an effective remedy.

For bringing an IIA claim, the IIA will need to be thoroughly scrutinised. We have seen cases where tribunals in distinct cases involving challenge to the same State measure under the same treaty have arrived at opposite conclusions - due to distinct interpretation of relevant treaty provisions.

With respect to influence on existing treaty claims in the pending Cairn – Vedanta international arbitrations, the Vodafone award may not have significant effect. The arbitration proceedings in the Cairn case were completed in December 2018. The award is awaited since February 2019. It is unlikely that the Vodafone award would have a bearing on Cairn award which is expected anytime. In any event, the investment treaty arbitration regime does not follow the doctrine of *stare decisis*, according to which an award by one arbitral tribunal binds the other. Additionally, the Cairn dispute differs from the Vodafone case with respect to treaty provisions attracted, Indian measures challenged, and claims made by Cairn.

Government’s position

This award negates India’s general position that tax disputes do not come under the ambit of investment treaties. However, the position holds water for treaties that specifically exclude tax disputes from their scope. New bilateral investment treaties entered into by India such as the 2018 India Belarus BIT and the 2020 India Brazil BIT have mostly excluded measures regarding taxation or enforcement of taxation obligations from their scope. Going forward, it is likely that India will fiercely negotiate on incorporation of such exclusions in bilateral investment treaties.

As for sovereign powers of India to pass retrospective legislation, the Finance Minister recently commented that India has sovereign powers to amend its laws. However, these amendments are required to have prospective effect.[5] We wait to see if India decides against challenging the Vodafone award, and honours its international law obligations under the Vodafone award.

EXAMINING INDIA’S SOVEREIGN POWERS TO PASS RETROSPECTIVE TAX LEGISLATIONS UNDER INTERNATIONAL LAW

What did the retrospective tax legislation achieve? Could India have balanced its sovereign powers with its international obligation to guarantee fair and equitable treatment to Vodafone?

To delve deeper into the retrospective tax legislation that fuelled the Vodafone case and analyse it on the pedestal of international law, stay tuned for Part II of our series tomorrow.

[1] Civil Appeal No.733/2012

[2] https://www.dea.gov.in/bipa

[3] Pohl, J. (2013), *Temporal Validity of International Investment Agreements: A Large Sample Survey of Treaty Provisions*, OECD Working Papers on International Investment, 2013/04.

[4] https://www.livemint.com/news/india/government-plans-new-law-to-protect-foreign-investment-11579084078405.html

[5] https://economictimes.indiatimes.com/markets/stocks/news/view-balancing-state-regulation-investor-rights/articleshow/73792172.cms

[6] https://economictimes.indiatimes.com/news/economy/policy/i-have-an-open-mind-about-stimulus-finance-minister-nirmala-sitharaman/articleshow/78396960.cms

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