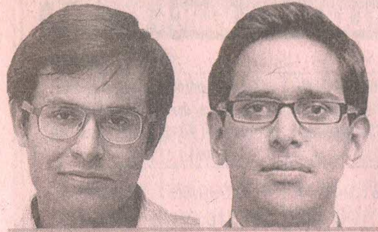
Capital controls undermine arbitration potential

Only a total overhaul of the capital controls regime under Fema can help improve legal certainty in enforcing international arbitration awards



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The recent Delhi High Court judgment in the Tata-DoCoMo case has provided much-needed respite to the Indian arbitration bar. By allowing enforcement of the foreign arbitration award in India, the court has reinstated India's image as an arbitration-friendly jurisdiction. However, this judgment also underscores the fact that improving arbitration law alone will not help improve the Indian arbitration ecosystem. If India has to boost investor confidence in its arbitration framework, the current Indian capital controls regime has to be streamlined.

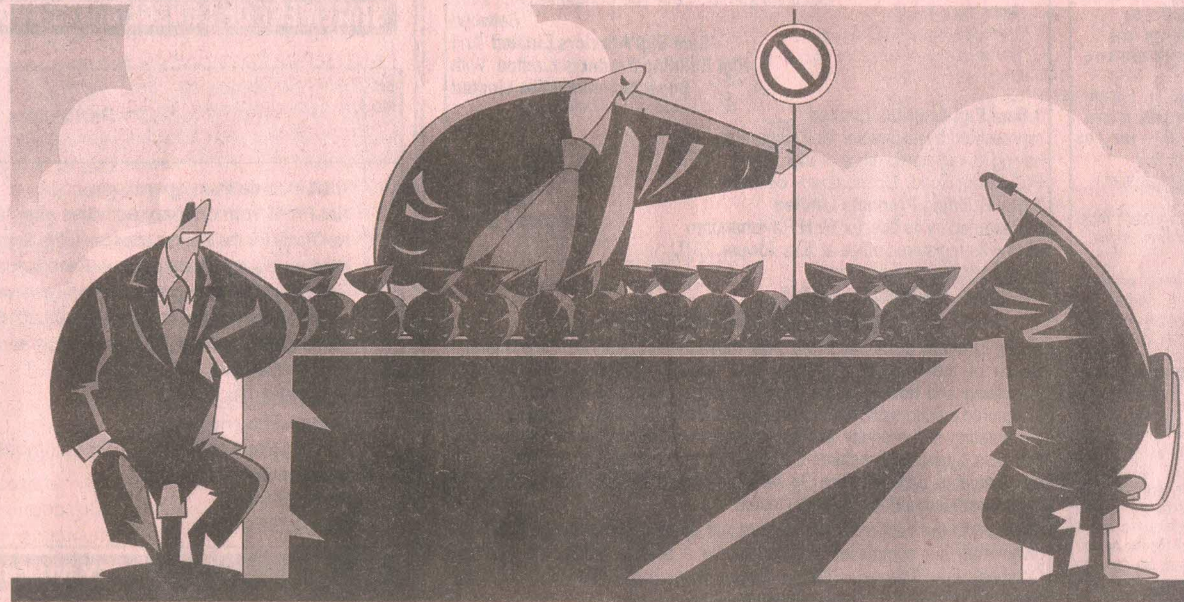
Arbitration awards often require the losing party to pay the winning party. In international arbitration, such payment could amount to a cross-border flow of capital. This could potentially conflict with capital control regulations, which aim to regulate the flow of capital in and out of a country. This is precisely what happened in the Tata-DoCoMo case.

Most developed economies, including the major hubs for international arbitration, do not experience any conflict between their arbitration regime and capital controls. This is because they usually refrain from imposing capital controls. For instance, UK abolished capital controls in 1979 under Margaret Thatcher's leadership. Singapore abolished capital controls in 1978. By contrast, India still retains capital controls through the Foreign Exchange Management Act, 1999 (Fema). Fema gives the Reserve Bank of India (RBI) unfettered discretion to regulate capital account transactions. The RBI has over time created a maze of obtuse regulations, which prejudice the ease of doing business in India. No amount of arbitration law reform can compensate for this regulatory maze. The Tata-DoCoMo episode is a classic example of how capital controls unnecessarily complicate enforcement of international arbitration awards in India.

When DoCoMo invested in Tata's Indian telecom company (TTSL) in 2009, the Shareholders' Agreement (SHA) stated that DoCoMo would not lose more than 50 per cent of its investment in TTSL. It gave DoCoMo the comfort of an exit option from TTSL. If DoCoMo triggered this option, Tata was required to find a buyer willing to buy DoCoMo's shares in TTSL at a price at least 50 per cent of what DoCoMo originally invested — "sale price". On failure to do so, Tata was required to buy Docomo's shares and indemnify DoCoMo for the difference between the "sale price" and the price at which Tata purchased the shares.

In 2014, when DoCoMo wanted to exit TTSL, Tata could neither find a buyer nor was it willing to buy the shares from DoCoMo at the predetermined price. Tata cited Fema regulations that prohibited a non-resident (DoCoMo) from transferring shares of an Indian company (TTSL) to a resident (Tata) at a predetermined price — in this case, 50 per cent of DoCoMo's original investment.

Tata even applied to the RBI for special permission for this transaction. The factual background detailed in the arbitration award shows that opinions differed within the RBI itself as to whether special permission should be granted. Eventually a decision was taken to seek guidance from the Ministry of Finance. Despite the RBI's recommendation that an exemption be provided, the Ministry of Finance was not in favour of creating an exception for an individual proposal. As a result, RBI refused to give special exemption for this transaction. Consequently, DoCoMo resorted to arbitration seated in London.



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The London Arbitral Tribunal noted that the Fema regulations permit transfer of shares from one non-resident (Docomo) to another non-resident at any price. Since Tata had failed under the agreement to get a non-resident buyer for DoCoMo's shares, the tribunal asked Tata to pay up "damages" to DoCoMo for the losses caused. Effectively, the arbitration award permitted Tata to pay DoCoMo through "damages" what Tata could not have directly paid Docomo because of the unnecessarily cumbersome Fema regulations.

Most interestingly, neither Tata nor DoCoMo opposed enforcement of the arbitration award before the Delhi High Court. Instead, it was the RBI which opposed the enforcement, although it was not even a party before the court. The RBI alleged that the award violated capital controls and its enforcement would be against the Indian public policy. The Delhi High Court rejected the RBI's plea and allowed enforcement of the award.

This inherent friction between capital controls and arbitration has received considerable regulatory and judicial attention in India lately. Apart from Tata-DoCoMo, the Delhi High Court has had to recently consider similar issues in a dispute involving Cruz City Holdings and Unitech Limited. The court permitted the enforcement of contractual obligations undertaken by the parties — and did not allow the Indian capital controls framework to be used as a defence by Unitech Limited against enforcement of a foreign arbitration award.

These judgments are a clear indication that the Indian judiciary is supportive of international commercial arbitrations. Even our current arbitration statute facilitates enforcement of international awards. Yet, complicated capital control regulations continue to hamper enforcement of international arbitration awards in India. This inherent conflict between capital controls and the arbitration framework seriously undermines India's potential as a pro-arbitration jurisdiction.

This problem in unique to India. Arbitration-friendly developed economies do not face this problem as they do not impose capital controls. Against this unique backdrop, Indian policymakers need to question the very utility of Fema in India today. The "sector-wise approval" approach for foreign investment contained in Fema has lost much of its relevance today. Most sectors are now under automatic route and government approval is not necessary. Further, the primary agency granting approvals — the Foreign Investment Promotion Board (FIPB) — is itself destined to be abolished in the near future. Keeping in tune with these reforms, it is high time Indian policymakers start considering a complete overhaul of the capital controls regime under Fema. Only such a fundamental reform can help improve legal certainty in enforcement of international arbitration awards in India.

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