Investment Funds: Monthly Digest

July 31, 2020

AIFS AND ARBITRABILITY OF AIF DISPUTES - JULY 2020

Structuring of investments through investment funds has evolved significantly over the past seven to eight years in India, boosted by the introduction of specific regulations in relation to Alternative Investment Funds (or "**AIFs**") by the Securities and Exchange Board of India ("**SEBI**") in 2012 i.e. the SEBI (Alternative Investment Funds) Regulations 2012 (the "**AIF Regulations**").

With the introduction of tax pass-through status for AIFs by the Finance Act, 2015, the market saw a considerable increase in AIF structures being used for investing into India. Most of these funds are in their fourth or fifth year of operations, with a typical fund life of ten to twelve years. In practice (as global trends suggest), investment funds often run into disputes in the second half of their lifecycle, i.e. after having raised the fund entirely.

As is common with commercial contracts, the governing documents of an AIF also contain the mechanism for dispute resolution between different parties. In this regard, the AIF Regulations also enable AIFs to set out the dispute resolution mechanism being adopted by the AIF in its governing documents.[1]

In the above backdrop, an emerging preference amongst GPs (fund managers) and LPs (fund investors) globally, is to opt for arbitration as the mechanism for dispute resolution, if the amicable efforts to resolve the dispute fail. However, for AIFs set up as trusts, arbitrability of disputes arising under the charter document of the trust (i.e. the indenture of trust / the trust deed) is currently unclear due to the Supreme Court of India ("**SC**") judgment in the case of *Vimal Shah and Ors. v. Jayesh Shah and Ors.*[2] ("**Vimal Shah Judgment**"). The implications of the Vimal Shah Judgment have been considered elaborately in our previous hotline, accessible **here**.

While the issue on arbitrability of trust disputes may not be impacting the industry today, it could cause unreasonable delay to the affected parties in future when they are looking to enforce their rights in an efficient manner in India. To this end, the Indian Trusts Act, 1882 ("**Trusts Act**") may have to be relooked at from the perspective of the rapidly growing funds market in India.

In this issue of the monthly digest, we discuss in detail the reasons why disputes arising under the trust deed of a trust registered as an AIF should be arbitrable, and it should be clarified that the Vimal Shah Judgment would not apply to AIFs set up as trusts.

WHAT IS THE LEGAL ISSUE?

AIFs are permitted to be set up in India as companies, trusts, limited liabilities, or body corporates.[3] The preferred mode of incorporation of a fund to operate as an AIF is typically a trust structure, for a variety of commercial considerations (which have been discussed at length in a previous issue of our monthly digest, accessible **here**).

The Vimal Shah Judgment, while dealing with dispute resolution in the context of a family trust, considered two key issues for arriving at their judgment, as follows:

1. To satisfy the test under Section 7 of the Arbitration Act, 1996 ("**Arbitration Act**"), **whether there existed a written agreement signed by the parties to the dispute which would evidence an arbitration agreement**.[4] Holding that as no written agreement existed in the specific case, the test under Section 7 failed. The aforementioned observation in essence, relates to the doctrine of privity of contract between parties to a trust structure, discussed in detail below.
2. Whether there existed ***an implied bar under the Trusts Act which excludes applicability of other acts for disputes arising under the Trusts Act,*** and the SC responding to this question affirmatively,[5] stated that such disputes are not capable of being referred to private arbitration for their adjudication on merits. The ratio appears to be based on the intrinsic nature of trust disputes, which are not capable of being treated as a right in rem *inter se* the trust and the beneficiaries.

Analysis of the SC's reading of the Trusts Act

In the context of the implied bar on arbitrability of trust disputes under the Trusts Act, it is known that there exist several provisions under the Trusts Act which grant certain powers to the Civil Court of original jurisdiction such as power to approve settlement a trust on behalf of a minor[6], power to give consent to change in terms of the trust on behalf of an incompetent beneficiary[7], power to hear a petition by trustee regarding management of trust-property[8], etc.

The Trusts Act, however, does not impose any express bar on a mutual decision by the trustee and the beneficiaries to apply arbitration as a mechanism of dispute resolution among them. This has been acknowledged by the SC in the

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Vimal Shah Judgment as well. However, the SC has imposed an implied bar through its interpretation of the Trusts Act in the Vimal Shah Judgment, as highlighted above relying on the principle that on merits, certain disputes are simply not capable of being arbitrated. In cases where rights of persons in rem, disputes thereto, would not be deemed arbitrable.

In relation to this rationale, SC has previously considered[9] the exclusion of arbitration as a mode of dispute resolution where a party enjoys statutory protection and where only special courts are conferred jurisdiction.[10] To this end, while the SC has referred the matter to a larger bench[11], it also noted an important principle while considering whether arbitration of disputes under the Transfer of Property Act, 1882, is excluded by virtue of a similar argument that in case of tenancy agreements, the rights possessed by the tenant are rights in rem and not personam, and held that, "*In fact, none of the aforesaid provisions would indicate that disputes under the said Act are triable only by the civil court and not by arbitration, as has been held in this paragraph. It is clear that the Transfer of Property Act is silent on arbitrability, and does not negate arbitrability*".

The abovementioned principle may also hold good similarly, in case of the Trusts Act. The provisions under the Trusts Act which refer to the Civil Court of original jurisdiction are specific and not exhaustive, and do not provide an explicit bar on arbitrability of disputes thereunder[12]. There could be disputes arising between the trust parties on matters which are not covered by the said provisions under the Trusts Act, especially for trusts registered as AIFs.

Accordingly, the SC's conclusion that there is an implied bar on arbitrability of trust disputes should be reconsidered.

Application of the doctrine of privity of contracts by the SC

The SC in the Vimal Shal Judgment also observed that an arbitration clause in a trust deed does not meet the requirements of a valid arbitration agreement as prescribed under the Arbitration Act, due to want of proposal and acceptance inter se the trustee and the beneficiaries. To examine the rationale behind the implied bar on arbitrability of trust disputes, the common law principle of the 'privity of contracts' which embodies the rationale the SC put forth in the Vimal Shah Judgment and the exceptions to this doctrine may be considered. The principle essentially means that only parties to an agreement can enforce rights and liabilities against one another. There are two aspects of the principle, namely: [13]

a. Only parties to a contract are entitled to benefits arising out of it;
b. No third party can be imposed with obligations under a contract between two parties.

Without specifically delving into the merits of this principle, the SC in the Vimal Shah Judgment, while considering existing jurisprudence[14] and based on the facts, concluded that no written arbitration agreement existed by the very nature of a trust. The SC also observed that to argue that trustees and beneficiaries have become parties to the terms of the trust deed by their conduct would require the absurdity of visualizing them agreeing among themselves to carry out every provision by making a proposal and acceptance.

The SC's analysis of the principle may be factually applicable to the case being considered; however, in the context of AIFs, the analysis would become inapplicable because the beneficiaries are given certain rights with respect to the trust in the AIF Regulations as well (without the requirement of having become a party to the trust deed).[15]

While this is a commonly accepted principle, Courts across the world have also contributed to the development of jurisprudence on exceptions to this doctrine[16]. Cases involving family and marriage settlements, creation of charge and multilateral contracts are some examples of the exception to privity of contracts.

One such recognised exception to the doctrine of privity to contract is the concept of 'third-party beneficiary' which is often seen in the formation of trusts. This equitable exception was applied in India by the Privy Council in *Khwaja Muhammad Khan v Husaini Begam*[17], that stated that where an obligation in equity amounting to a trust arising out of the contract exists, the beneficiary has a right to sue.

The impact of this exception means essentially that third party beneficiaries, even though not signatory to the agreement, have been allowed to approach the Courts to have their rights under the agreement enforced. It may be noted that courts have shown reluctance to apply this exception easily and require the intention to create a trust and to benefit the third party for it to come into effect. The Courts have also laid down several tests to determine the intention of parties and often look at the use of express words like 'trustee' or 'trust'[18] and nearness of relationship between the parties in this regard.[19]

The conclusion from the above jurisprudence surrounding the concept of privity of contracts has bearing on the analysis of the Vimal Shah Judgment. It may be noted, that the doctrine of privity of contracts while being an established principle has undergone significant evolution with passage of time and with commercial transactions becoming more complex, exceptions to this doctrine have accordingly been developed by courts, as seen from the abovementioned judgments.

AIFs have a distinct nature that set it apart from other non-commercial trust structures. Investors in an AIF structure are typically identified by the manager beforehand, and these investors are aware of their rights and obligations under the fund documents. Practically, these investors also possess a higher bargaining power and specifically insist on reviewing the terms of the fund structure and documents, prior to providing their consent / investing in the fund. Given that in such cases consent of the beneficiary (i.e. the investor is specifically obtained under the fund documentation), privity would be said to be sufficiently established inter se, it may be safe to state such situations in case of AIF structures, form ample exception to the doctrine of privity of contract. Therefore, not extending the benefit of the exception to this doctrine to AIFs, especially when AIF Regulations also stipulate this framework, may seem like a step back for the growth of trust structures in India.

Therefore, specifically in the context of AIFs, the implied bar on arbitrability of trust disputes should be reconsidered.[20]

HOW DOES IT IMPACT AIFS?

The AIF Regulations were notified with the objective of making India a global hub of pooled investments. These

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regulations provide for the creation of three different categories of private pooling vehicles depending on the kind and extent of risk involved.

As mentioned above, Regulation 25 of the AIF Regulations allows room for the investors and the AIF to choose any method of dispute resolution as they deem fit, including arbitration if the same is provided for in the fund documentation of the AIF.

In the above regard, certain issues arise, such as, whether the AIF Regulations be given precedence over principles set out in the Vimal Shah Judgment, as supported by the amended Trusts Act or would the Vimal Shah Judgment prevail in terms of the third party beneficiaries of the AIF i.e. the investors. A noted principle in cases of interpretation of legislations is, '*lex specialis derogat legi generalia*' i.e. laws governing a specific subject matter prevail over general laws. In this context, an important consideration is that the AIF Regulations are narrow in their scope of applicability; they apply to trusts which are specifically set up as AIFs, and therefore, the general discussion surrounding arbitrability of AIF disputes would not impact disputes of trusts not set up as AIFs.

Additionally, the governance of a fund, is a complex issue with the fiduciary obligation towards multiple investors being at stake. An example of this is the notable Weavering case.[21] Briefly, the case pertained to mismanagement and allegations of fraud by a UK based investment manager of a Cayman Islands fund in question, which involved multiple issues including false determination of net asset value and subsequent payouts, which severely impacted all investors. The aforementioned matter was heard by Court of Appeal in the Cayman Islands and subsequently appealed and heard by the Privy Council in UK, which passed its order on July 29, 2019. The impugned redemptions by the fund which formed the matter of the appeals, took place between 2008 – 2009.

Given the complexity of fund governance, substantial time and resources are required when delving into each aspect surrounding a dispute as the ultimate affected parties are the investors. In the Indian scenario, it is known that courts are presently burdened with numerous cases which are not just restricted to commercial litigation. In such a scenario, having arbitration as a mode of dispute resolution in cases of commercial disputes, including for AIF disputes, seems a viable option as compared to litigation in courts. This becomes especially important with interest of foreign investors being piqued in India as the destination for investments. Globally, investors gravitate towards arbitration as a mode of dispute resolution due to the emergence of specialized arbitration institutions which focus on and possess the necessary expertise to resolve commercial disputes, efficiently and timely.

It is important to note that the AIF Regulations also provide adequate freedom to AIFs to determine the mode of their dispute resolution within the fund documents. With the emergence of complex fund structures, the AIF fund documentation has also undergone significant changes in the present scenario with investors possessing a higher bargaining power in terms of their rights under the fund documentation.

At present, fund counsels in India have evolved different contractual measures to deal with this legal issue in the context of AIFs to be able to assist GPs in providing ample comfort to LPs (including by way of designing the terms of the contribution agreement in a manner which encompasses trust related aspects).

CONCLUSION

The Vimal Shah Judgment continues to occupy the field of test of arbitrability in India. With AIFs gaining popularity in India, restricting AIFs set up as trusts from opting for arbitration as a mode of dispute resolution in the present day, may disadvantage both the GPs and LPs ultimately. Given the analysis above, it appears a ripe time for the arbitration sphere surrounding AIF disputes to consonantly evolve as well.

– Sanjana Rao, Nandini Pathak & Vyapak Desai
You can direct your queries or comments to the authors

[1] Regulation 25 of the AIF Regulations.

[2] Civil Appeal No. 8164 of 2016.

[3] Regulation 2(1)(b) of the AIF Regulations.

[4] The SC in this regard observed that in cases of trusts, "*the trustees or/and beneficiaries are only required to carry out the provisions of the Trust Deed. There cannot, therefore, be any agreement inter se trustees or beneficiaries to carry out any such activity. If that were to be so then the trustees/beneficiaries would have to give proposal and acceptance in respect of each Clause of the Trust Deed inter se. It would be then a sheer absurdity and hence such situation, in our view, cannot be countenanced.*"

[5] The SC held that, "*though the Trust Act do not provide any express bar in relation to applicability of other Acts for deciding the disputes arising under the Trust Act yet, in our considered view, there exists an implied exclusion of applicability of the Arbitration Act for deciding the disputes relating to Trust, trustees and beneficiaries through private arbitration. In other words, when the Trust Act exhaustively deals with the Trust, Trustees and beneficiaries and provides for adequate and sufficient remedies to all aggrieved persons by giving them a right to approach the Civil Court of principal original jurisdiction for redressal of their disputes arising out of Trust Deed and the Trust Act then, in our opinion, any such dispute pertaining to affairs of the Trust including the dispute inter se Trustee and beneficiary in relation to their right, duties, obligations, removal etc. can not be decided by the arbitrator by taking recourse to the provisions of the Act. Such disputes have to be decided by the Civil Court as specified under the Trust Act.*"

[6] Section 7 of the Trusts Act.

[7] Section 11 of the Trusts Act.

[8] Section 34 of the Trusts Act.

[9] Vidya Drolia and Ors. vs. Durga Trading Corporation, Civil Appeal No. 2402 of 2019 (Arising out of Special Leave Petition (C) No. 22211/2018).

[10] Natraj Studios (P) Ltd. vs. Navrang Studios and Ors. (1982) 2 CompLJ 551 (SC)

[11] Supra No.9. The SC in this case, has also noted the Vimal Shah Judgment stating that disputes under the Trusts Act by nature are not capable of being referred to arbitration.

[12] Supra No. 5. As has also been noted by the SC in the Vimal Shah Judgment.

[13] Dunlop Pneumatic Tyre Co Ltd v Selfridge & Co Ltd [1915] UKHL 1.

[14] Ballav Kundu & Anr. Vs. Tapeti Ranjan Kundu, AIR 1965 Calcutta 628.

[15] Regulation 13 of the AIF Regulations permits extension of the tenure of a closed-end Fund subject to approval of 2/3rd unitholders by value; Regulation 29 stipulates resolution by 75% investors by value to be a valid condition leading to winding-up of the Fund.

[16] Such as in the case of Khwaja Muhammad Khan v Husaini Begam, (1910) ILR 32 All 410.

[17] Ibid..

[18] Desraj v Ralli Ram, AIR 1957 J&K 10.

[19] Veeramma v Appayya, AIR 1957 AP 965.

[20] It is pertinent to note that amendments to Section 8 of the Arbitration Act appeared to temper the aforesaid judgment to some extent.

[21] Skandinaviska Enskilda Banken AB (SEB) v Conway and another (as Joint Official Liquidators of Weavering Macro Fixed Income Fund Ltd) (Cayman Islands) [2019] UKPC 36.

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