Journal for Law & Justice (JLJ)
(Volume I | Issue I 2025)

# SOVEREIGNTY ON TRIAL: THE CAIRN ENERGY V. INDIA ARBITRATION AND THE FUTURE OF INTERNATIONAL LAW IN INVESTOR-STATE DISPUTES

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## I. INTRODUCTION

None of the controversies has so vividly shown the thin border between sovereign prerogative and international legal restraint as *Cairn Energy Plc & Cairn UK Holdings Ltd. v. Republic of India*[1]. In December 2020, the tribunal convened in accordance with the India-UK Bilateral Investment Treaty and advised India to pay more than USD 1.2 billion in damages to Cairn Energy Plc, ruling that the retrospective taxation system in India had infringed the guarantees of fair and equitable treatment under the treaty and constituted an unlawful expropriation.[2]

The controversy itself was centered on the Finance Act, 2012 of India - a legislative gimmick which retroactively revised the Income Tax Act to encompass indirect transfers of Indian property as early as 1962.[3] The amendment, although excused as a matter of fiscal sovereignty, impacted legitimate investor expectations and generated one of the best-documented investor-State conflicts in the past decade. The further implications on the global significance of the case were the enforcement measures that followed by Cairn in the effort to seize Indian sovereign assets across various jurisdictions.[4] This commentary on the case places Cairn v. India in the bigger picture of investment treaty arbitration. It reviews three major elements of the award: (i) how the tribunal may treat the carve-out of taxation in the BIT, (ii) how to state legitimate expectations where the fair and equitable treatment standard is applied, and (iii) the problematic issue of application of arbitral awards when sovereigns are defiant. It therefore states that although this ruling enhances the rule of law in investment protection, it also disrupts the borders of democratic sovereignty and the independence of the domestic fiscal policy.

## II. FACTUAL BACKGROUND

The conflict can be traced back to the restructuring of Cairn Energy in 2006, as this deal was made under full disclosure, and the existing system of Indian taxation. Cairn physicalised shares of its Indian subsidiary, Cairn India Limited, from a UK holding company to its Indian subsidiary, an internal reorganization to simplify future operations before an eventual public offering could be made. No capital gains tax liability accrued in the Indian law at the time, and the transaction was specifically cleared by the regulatory authorities.[5] This changed radically in 2012 with the enactment of the Finance Act into law by the Indian Parliament, a statute that retrospectively amended the Income Tax Act to include indirect transfers of Indian assets dating back half a century.[6] Allegedly, being an attempt to clarify the situation concerning the ruling of

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[1] Cairn Energy Plc & Cairn UK Holdings Ltd. v. Republic of India, PCA Case No. 2016-7, Award (Perm. Ct. Arb. Dec. 21, 2020).

[2] *Id.* pp. 823–825.

[3] Vodafone Int' l Holdings B.V. v. Union of India, (2012) 6 S.C.C. 613.

[4] *Ibid*.

[5] *Supra note* 1, pp. 125–130.

[6] India-U.K. Bilateral Investment Treaty, § art. 9, March 14, 1994, 1765 U.N.T.S. 33.

the Supreme Court in the case of *Vodafone International Holdings v. Union of India*, literally reopened an area of transactions that were regarded as closed to attack the very idea of legal certainty.[7] It is based on this that the Indian tax officials have made a demand of around INR 10,247 crore (USD 1.6 billion) to Cairn and have also frozen dividends, transfer of shares, and any other proceeds due to the company.[8] Cairn was confronted with what it termed as arbitrary and confiscatory measures; it launched arbitral proceedings in 2015 under the India-UK Bilateral Investment Treaty (1994). Drawing on the commitments of the treaty in terms of fair and equitable treatment, protection against expropriation, and the right to international arbitration, Cairn claimed that Indian actions were not only a breach of its legitimate expectations as an investor but also the implementation of taxation against international law. The arbitration was conducted in accordance with the UNCITRAL Rules, in which The Hague was selected as the seat and a tribunal of three persons appointed to hear the case.

## III. ISSUES BEFORE THE TRIBUNAL

The Cairn arbitration case compelled the tribunal to wrestle with issues that cut right to the bone of the investment treaty regime. The dispute was framed by three issues specifically.

a. The tribunal was to start with, required to establish its jurisdiction, considering the carve-out in taxation as stated by the India-UK BIT. India claimed that the controversies surrounding the actions of taxation were not a part of the treaty and could not be discussed under the arbiter. Cairn, on its part, argued that its case was not against how India had exercised its sovereign authority to tax per se, but the means in which it had exercised it--retrospectively, selectively, and in violation of treaty principles. The question was, could the exercise of fiscal powers be sheltered against international review by simply referring to the term taxation?[9]
b. The tribunal had to evaluate the issue of whether the imposition of retrospective tax and the confiscation of assets that followed the retrospective tax was in breach of the Fair and Equitable Treatment (FET) standard of Article 3(2) of the BIT. At the heart of this question lay the doctrine of legitimate expectations: can an investor have a reasonable expectation that a host State would not make retroactive changes in its taxation laws and that doing so would discredit the legal basis on which the investment was made?[10]
c. The tribunal needed to determine whether or not the activities of India constituted illegal expropriation. Did the State exceed the boundary between lawful taxation and uncompensated deprivation of property by freezing the dividends of Cairn, seizing shares and preventing proceeds of the sale of its Indian assets in violation of Article 5 of the BIT?[11]

Combined these concerns condensed a bigger question: how far the sovereign prerogatives of a State, especially the power to tax, are open to the sanctions of international law, after the commitments of a treaty are made.

[7] Tecnicas Medioambientales Tecmed S.A. v. United Mexican States (Tecmed), ICSID Case No. ARB(AF)/00/2, Award para. 154 (May 29, 2003).
[8] *Supra note* 6, § art. 5.
[9] *Supra note* 1, para. 340–350.
[10] *Id.* para. 538–545.
[11] *Id*. para. 580–600.

## IV. TRIBUNAL'S FINDINGS

The tribunal based at the Hague under the UNCITRAL Arbitration Rules finally decided in favour of Cairn decisively. Its grant of more than USD 1.2 billion in damages, interest, and costs was based on three very significant determinations.

### A. The Taxation Carve-Out Still Did Not Support Jurisdiction

The tribunal overturned the objection of India and found that the dispute was not under the taxation exception of the treaty. Although the sovereigns have broad latitude in the formulation and execution of the fiscal policies, they cannot act beyond scrutiny when they act in a way that is against the standards of the binding treaties. The tribunal established its authority by putting the dispute in the context of investment treatment issues and not the legality of taxation itself.[12]

### B. Breach of Fair and Equitable Treatment (FET)

The key argument of the tribunal was the principle of legitimate expectations. In 2006, Cairn had planned its investment in India in full accordance with the Indian laws, where the legal framework did not collect tax on indirect transfer. This framework was shaken by the retrospective amendment of 2012 and made a closed transaction liable. The tribunal found that such an act was not transparent, predictable, and proportional, thus contravening the FET standard as enshrined in the BIT.

### C. Unlawful Expropriation

The court also concluded that the actions by India, especially the freezing of the dividends of Cairn, the taking of its shares, and the blocked sale of its assets, were indirect expropriation. These actions denied the investor the worth and pleasure of its investment without speedy, sufficient, or efficient recompense, which is a breach of Article 5 of the BIT.[13]

Overall, the tribunal decided that the retrospective taxation regime of India applied to Cairn was a manifestation of an arbitrary and coercive deviation of international standards. It caused restitution in the form of damages and ordered India to forbear its challengeable tax claim.

### D. Enforcement Struggles

The award being issued in December 2020 did not end the dispute; it only changed the battleground to enforcing courts across the world. The inability of India to do so voluntarily pushed Cairn into the unwinnable, multi-jurisdictional drive to obtain payment, a tactic that pushed the boundaries of sovereign immunity in the law of the international community.

### E. Litigation Of Air India In The United States

In the Southern District of New York, Cairn petitioned to seize the property of Air India, claiming that the national carrier was an alter ego of the Indian State. Through piercing the corporate veil, Cairn argued that the property of Air India could be regarded as being identical to the property of the sovereign. The case, which eventually fell into settlement, however, indicated the increased readiness of investors to use alter ego doctrines against government-owned corporations.

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[12] Cairn Energy Plc v. Republic of India & Air India Ltd., Petition to Confirm Award, S.D.N.Y. (2021).

[13] Tribunal de grande instance [TGI], Paris, July 2021 (France).

### F. Seizures In France

The strongest attempt at such enforcement was perhaps the one made in Paris, the French court ordering the seizure of twenty Indian-owned properties by the government. Cairn selectively used non-diplomatic property without breaching the Vienna Convention on Diplomatic Relations (1961), so as to put additional strain on India without resorting to international immunity protection.

### G. Simultaneous Criminal Prosecutions

At the same time, Cairn was engaged in recognition and enforcement claims in the United Kingdom, the Netherlands, Canada, and Singapore. Through this multiplication of jurisdictions, Cairn was placing the maximum pressure on the law and increasing the reputational costs of India as an image of a State that does not like the rule of law.[14] The overall impact of these actions was forceful. Although India has denounced the measures as an insult to sovereignty, a move by Cairn pointed out the practical weakness of even the strong states in terms of the efficiency of the enforcement action through the New York Convention.[15] Finally, the stalemate was only resolved when the Indian Parliament rescinded the 2012 retrospective amendment in November 2021, coordinating a negotiated settlement. Cairn accepted to lift its enforcement measures in return for repayment of around USD 1 billion, which ended a turbulent history in the investment arbitration history of India.[16]

## V. CRITICAL ANALYSIS

The rationale of the tribunal in the case of Cairn v. India represents the positive and negative strains that are embedded in the investor-State dispute settlement (ISDS) regime. Its results are important in confirming the protection of investors, but they also raise justified concerns regarding the extension of the power of arbitration into the territory of sovereign finance.[17]

### A. Merits Of The Tribunal Rationale

The principle that the law of legal certainty and predictability is a pillar in international investment law was properly cemented by the award. The tribunal highlighted that States cannot revise legal frameworks without repercussions by acknowledging the legitimate expectations of Cairn. This gives a good precedent on not engaging in any arbitrary fiscal gambles in the guise of clarifications, and host States are reminded that treaties are not a temporary political luxury but a legal obligation. Furthermore, the approach of the tribunal to expropriation is a pragmatic interpretation that the loss of dividends, shares, and proceeds may be indirect expropriation even when there is no formal nationalisation.

### B. Weaknesses And Criticisms

Meanwhile, the ruling is subject to criticism because it suggests the sovereignty of democracies. Taxation is a classic type of sovereign activity, and the intervention of the tribunal makes it very awkward the possibility to challenge the authority to make fiscal policy through the intervention

[14] *Supra note* 1, para. 950–960.
[15] Taxation Laws (Amendment) Act, No. 30 of 2021, India.
[16] Ministry of Finance, Government of India, Press Release (Nov. 2021).
[17] *Supra note* 1, para. 530–540.

of the tribunal. Critics believe that questioning the power of the Parliament through the award will tend to favour the investor decision-making over the democratic process. Also, the fact that the tribunal did not uphold the carve-out argument of Indian taxation demonstrates that the palm of interpretation of BIT tribunals is elastic, which can create additional charges of regulatory chill of the ISDS system.[18]

### C. Comparative Insights

The Cairn award, put in context, is at the cross-border of two streams of arbitral jurisprudence. On the one hand, it appeals to Yukos v. Russia and Occidental v. Ecuador, whose taxation and fiscal policies were examined as expropriation tools.[19] Conversely, it is in contrast to Philip Morris v. Uruguay, where there were official tribunals that supported sovereign regulatory authority in the interest of the people. The tension shows that there are more unanswered questions: is the balance to be tipped in favour of the expectations of investors or the sovereign prerogatives when the two collide with each other?[20] In this sense, Cairn v. India represents not only the affirmation of the rule of law in investment arbitration, but also a warning of the dangers posed by tribunals going too far into the areas that have typically been closed to outsourcing.

## VI. INDIA AND INTERNATIONAL LAW OF INVESTMENT IMPLICATIONS

The Cairn award had an echo of a far longer length than the arbitral tribunal. To India, it is not only a billion-dollar burden but also a reputational crisis that revealed structural weaknesses in its interaction with international investment law. To the rest of the regime, it underscored the precarious nature of the State and the protection of investors.

### A. India's Legislative Retreat

The full-fledged reaction was legislative in August 2021, when the Indian Parliament abolished the retrospective tax clause under the Taxation Laws (Amendment) Act.[21] The repeal had the indefinite tincture of coercion, despite being configured as an investor-friendly measure, after consecutive losses in the Cairn and Vodafone arbitrations. The relocation was an implicit recognition that retrogressive fiscal policy is inconsistent with international principles of law certainty, although it may be politically correct at home.

### B. Treaty Retrenchment

At the policy level, India reacted in a dramatic and disengaged manner in the investment treaties framework. India cancelled over seventy BITs and presented its restrictive Model BIT of 2016 between 2015 and 2021. The Model BIT is a defensive stance and not a constructive recalibration by limiting the definition of investment, making arbitral review of taxation impossible, and mandating the exhaustion of local remedies.[22] Although the intention is to re-establish regulation independence, the strategy may have an isolating effect on India to the mainstream of investment governance and reduce investor confidence.

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[18] Gus Van Harten, *Investment Treaty Arbitration and Public Law* 45–47 (2007).

[19] Yukos Universal Ltd. v. Russian Fed'n, PCA Case No. AA 227, Final Award (Perm. Ct. Arb. July 18, 2014); Occidental Petroleum Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Award (Oct. 5, 2012), Philip Morris Brands Sàrl v. Oriental Republic of Uruguay, ICSID Case No. ARB/10/7, Award (July 8, 2016).

[20] James Crawford, *Brownlie's Principles of Public International Law,* 29–30, (9th ed. 2019).

[21] *Supra note* 18.

[22] Ministry of External Affairs, Model Text for the Indian Bilateral Investment Treaty (2016).

### C. Reputational Costs And Investor Perception

The reputational fallout was perhaps the most devastating. The international business lobbyists had threatened that there would be legal uncertainties in India, and the rating of the nation in terms of the foreign investment index declined. Seizing the sovereign assets overseas portrayed India as an insurrectionary creditor instead of a faithful treaty companion. The episode caused some questions to linger after the settlement regarding the credibility of India in regard to honouring its international obligations.

Furthermore, at the systemic level, Cairn v. India encapsulates the dilemma of the developing economies. Although BITs are a tool to open up the capital stream, they may also limit the sovereign policy space in politically sensitive spheres like taxation. The withdrawal of India from the system is a reflection of more general scepticism of emerging economies, but the lack of alternatives that are credible could undermine even the stability of the investment regime itself.[23] To this end, Cairn is a national point of inflexion to India and the world as a whole, in the renegotiation of investment treaty commitments. It shows that sovereignty in the 21st century is no longer the free hand of the State, but an obligation moderated by international law and by the demands of investors.[24]

## VII. CONCLUSION

The Cairn arbitration is a precedent of the attempt to push the boundaries of fiscal sovereignty as a part of international investment law. In annihilating the retrospective taxation regime in India, the tribunal has made it plain that the protection of investors under bilateral treaties cannot be subjugated to ex post facto legislative games however convenient they are. Meanwhile, the award has also sparked a larger controversy on whether or not arbitral intervention can be legitimate on the fiscal prerogatives of democratically elected governments.[25] To India, the incident has cost it dearly as well as being humiliating. The repeal of the amendment in 2012 and the settlement with Cairn was not a policy foresight move but rather a legal compulsion and reputational need. Nonetheless, following their demise, India has taken the retreatism route a step of ending its BITs and practicing a defensive model treaty, which endangers to isolate the State at the cost of investor trust.[26] The larger lesson of this case today is no longer that sovereignty which is no longer the protector of absolute autonomy but the model of responsibility as willingly adopted by international engagements. It is not in giving up the treaty system but in fixing it, in making sure that the States are still free to act in the common good, but investors are still free of randomness and confiscation. Until this harmony is achieved, there will be persistence of investor-State arbitration between charges of investor exceptionalism on the one hand and sovereign impunity on the other. Ultimately, Cairn is not so much of a warning on what arbitral over-reach can lead to as of a reflection on States themselves. It shows that the international investment order is not only founded on sovereign assertion but on sovereign reliability.

[23] UNCTAD, World Investment Report 2022, pg.78–80.
[24] UNCITRAL Working Group III, Report on Investor–State Dispute Settlement Reform, U.N. Doc. A/CN.9/1004 (2020).
[25] *Supra note* 1, para. 600–610.
[26] U.N. Charter, § art. 2, para.1.