

## HR Law Hotline

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### INDIAN LABOUR AND EMPLOYMENT LAW: INFORMATION TECHNOLOGY AND SOFTWARE DEVELOPMENT COMPANIES IN INDIA CATEGORISED AS 'FACTORIES'

Creation or development of software has been regarded as a manufacturing process and the premises where computers are used in the manufacturing process has been considered a 'factory' for the purpose of the Employees' State Insurance Act, 1948 ("ESI Act"), one of India's key social security enactments. This position was recently taken by the Bombay High Court, while delivering a judgment<sup>1</sup>, which is particularly relevant to establishments in the Information Technology (IT) and Information Technology Enabled Services (ITeS) sectors in India that are engaged in software development - an activity that is ordinarily considered to be a commercial activity within the scope of the State specific legislations applicable to shops and commercial establishments.

#### BACKGROUND

The ruling addresses two appeals on the same question of law pertaining to coverage of the IT industry under the ESI Act. The Employees' State Insurance Corporation ("ESI Corporation") is a common contesting party to both the appeals. The other parties in the appeals i.e. M/s. Western Outdoor Interactive Private Limited ("Company 1") and M/s. Reliable Software Systems Private Limited ("Company 2") are both establishments engaged in software development and ancillary activities using computers. In both cases the Employees' State Insurance Court ("ESI Court") adopted differing views on the same questions of law. Set out below is a brief overview of the facts in the two appeals:

**Appeal by Company 1** : A demand for contribution under the ESI Act was made by the ESI Court on Company 1, on the ground that it is a 'factory' as per the provisions of the Factories Act, 1948 ("Factories Act"). The same was challenged before the ESI Court, Mumbai. The ESI Court held that the activities carried out by Company 1 were essentially commercial activities and did not constitute a manufacturing process and hence Company 1 was held not to be a 'factory'. The ESI Corporation justified the demand for the contribution (for the period from 1st January, 2001 till 30th September, 2002) on the basis of the circular dated November 22, 2002 issued by ESI Corporation ("Circular") extending the applicability of the ESI Act to certain commercial activities and services. The ESI Court held that the circular could not be made applicable retrospectively and therefore quashed the application made by the ESI Corporation. Aggrieved by the order of the ESI Court, the ESI Corporation filed an appeal before the Bombay High Court.

**Appeal by Company 2** : The ESI Corporation raised a demand for contribution under the ESI Act for the period from 1998 to 2005 claiming Company 2 to be engaged in manufacturing activities. Company 2 filed an application under Section 77 of the ESI Act before the ESI Court challenging the coverage and claimed that the activities being carried out did not constitute manufacturing process and therefore, could not be brought within the scope of the said enactment. The ESI Court ruled that software development is a manufacturing process and held Company 2 to be a 'factory'. Aggrieved by the said order, Company 2 filed an appeal before the Bombay High Court.

#### ISSUES

The key issues before the Bombay High Court were:

- Whether creation of software or development of software itself is a manufacturing process?
- Whether the premises where computers are involved in a manufacturing process is a factory under the ESI Act?

#### ARGUMENTS AND KEY CONSIDERATIONS

The Circular brought, inter alia, the following establishments within the scope of 'shops' for the purpose of the ESI Act and thereby widened the ambit of the statute to cover employees engaged in such establishments:

- Call centers providing IT enabled services dealing with inbound and outbound customers servicing, mailing service, market research, telemarketing and other kind of customers contact solutions for various organizations;
  - Medical/Legal encryption/transcriptions services;
  - Dot-com companies providing a host of e-services including on line shopping;
  - Content development agencies engaged in providing IT enabled services such as developing websites, C-DAC/Cam/CAE/GIS product life cycle management, remote and photo grammatery, image processing, engineering services for various designs;
  - Computer training centers; etc.
- The counsel for Company 1 contended that the ESI Court rightly cancelled the notice of demand of contribution sent

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The counsel for Company 2 contended, inter alia, that:

- The company was engaged in providing online information to the share market traders regarding the position of shares in the share market and that the only use of computers was for the purposes of receiving, storing and transmitting the information to the clients in the stock market; and
- There is no question of development of any software and therefore the finding of the ESI Court is contrary to the law.

The counsel for both Company 1 and Company 2 submitted that computer related activities could not be treated as "manufacturing processes", particularly in the light of Explanation II of Section 2(m)<sup>2</sup> of the Factories Act.

The counsel for the ESI Corporation contended and submitted, inter alia, that:

- Company 1 and Company 2 are using computers and are not entitled to get benefit of the exemption under Explanation II of Section 2(m) of the Factories Act;
- Company 1 and Company 2 are using computers and are not entitled to get benefit of the exemption under Explanation II of Section 2(m) of the Factories Act;
- It is not necessary that the process should end in any substance being manufactured for the purpose of establishing that there is a manufacturing process being carried on; and
- Company 1 and Company 2 were carrying on manufacturing processes and therefore are 'factories'.

## RULING OF THE BOMBAY HIGH COURT

The Bombay High Court, after taking into consideration the definition of the term 'factory' under section 2(12) of the ESI Act<sup>3</sup> and the definition under section 2(m) of the Factories Act<sup>4</sup>, held that the definition of 'factory' under the ESI Act has a wider meaning as compared to the definition of same term under the Factories Act. The court further held that the meaning of the term 'factory' for the purpose of the ESI Act is not to be understood in the context of Explanation II of Section 2(m) of the Factories Act and that borrowing the meaning from the Factories Act would be a myopic view, defeating the object and spirit of the ESI Act.

In connection with the meaning of the phrase "manufacturing process" the court stated that that "the words 'manufacturing process' in different statutes have different meanings. For instance, in the Central Excise Act, 1944, the word "manufacture" means bringing into existence a different commodity, though this is not the definition of "manufacturing process" in the Factories Act, 1948. We cannot apply the definition of "manufacturing process" in one statute to another statute." The court further held that while computer related activities like development, programming and application have not been mentioned in the definition of 'manufacturing process', the definition of the phrase in the statute includes such activities.

With respect to the specific issues faced with, the Bombay High Court has ruled as below:

| No. | Issue   | Ruling |
|-----|---|--------|
| 1.  | Whether creation of software or development of software itself is a manufacturing process or not?             | Yes    |
| 2.  | Whether the premises where computers are involved in manufacturing process is a factory under the E.S.I. Act? | Yes    |

## ANALYSIS

The ESI Act is a social security enactment primarily applicable to establishments engaged in activities that may be considered to be manufacturing processes and extended to other establishments by way of specific circulars. Only employees who are employed in establishments to which the ESI Act applies and who earn less than INR 15,000 are entitled to benefits under the statute. This ruling of the Bombay High Court is important to the IT/ITeS industry, particularly companies engaged in activities that constitute 'software development'. In our view, while the classification as a factory, leading to the applicability of the ESI Act to the IT sector in general may not be an issue in view of the low salary threshold for coverage of employees, we believe that this ruling could limit the flexibility for the sector if some of the other labour laws are extended to this industry on the basis that software development is a manufacturing process.

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You can direct your queries or comments to the authors

<sup>1</sup> Joint Appeal: The Assistant Director Employees' State Insurance Corporation Marol vs. M/s. Western Outdoor Interactive Private Limited (First Appeal No. 143 of 2012) and M/s. Reliable Software Systems Private Limited vs. Employees' State Insurance Corporation Regional Office, Marol (First Appeal No. 307 of 2012). Judgment pronounced on July 11, 2012.

<sup>2</sup> Section 2(m) "factory" means any premises including the precincts thereof-

(i) whereon ten or more workers are working, or were working on any day of the preceding twelve months, and in any part of which a manufacturing process is being carried on with the aid of power, or is ordinarily so carried on, or  
(ii) whereon twenty or more workers are working, or were working on any day of the preceding twelve months, and in any part of which a manufacturing process is being carried on without the aid of power, or is ordinarily so carried on,--  
but does not include a mine subject to the operation of the Mines Act, 1952 (35 of 1952), or a mobile unit belonging to the armed forces of the Union, railway running shed or a hotel, restaurant or eating place.

Explanation I--For computing the number of workers for the purposes of this clause all the workers in 10 different groups and relays in a day shall be taken into account;

Explanation II.--For the purposes of this clause, the mere fact that an Electronic Data Processing Unit or a Computer Unit is installed in any premises or part thereof, shall not be construed to make it a factory if no manufacturing process is being carried on in such premises or part thereof.

<sup>3</sup> Section 2(12) "factory" means any premises including the precincts thereof whereon ten or more persons are employed or were employed on any day of the preceding twelve months, and in any part of which a manufacturing process is being carried on or is ordinarily so carried on, but does not include a mine subject to the operation of the Mines Act, 1952(35 of 1952) or a railway running shed.

<sup>4</sup> Supra 2

but does not include a mine subject to the operation of the Mines Act, 1952 (35 of 1952), or a mobile unit belonging to the armed forces of the Union, railway running shed or a hotel, restaurant or eating place.

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