THE HORIZON

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News Update

Making Headlines

Notable Speakership

'Options' & Enforceability in India

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‘Options’ & Enforceability in India

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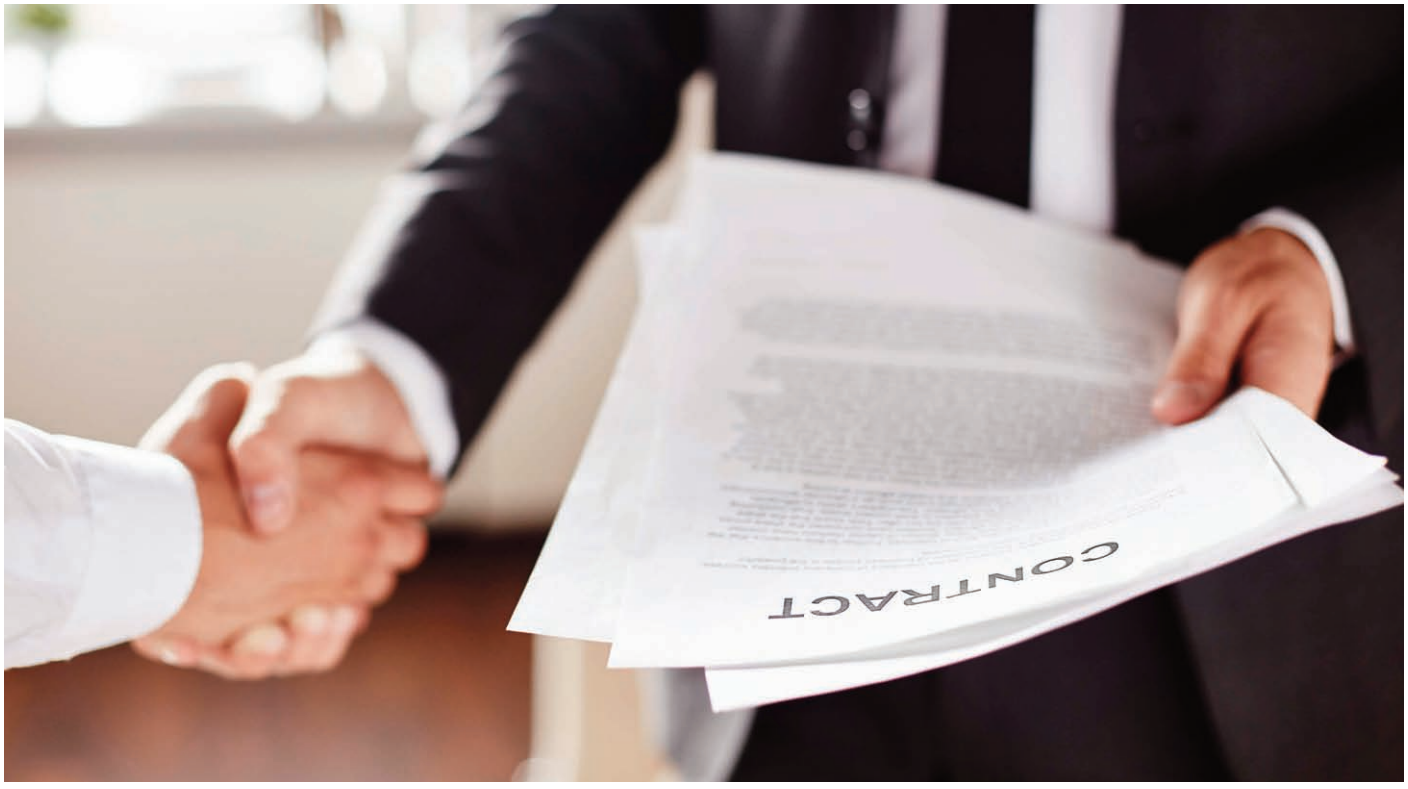


In an investment transaction, whether strategic or financial, an exit option always provides flexibility to an investor(s) to sell its securities on occurrence or non-occurrence of certain specified events in the future at a pre-determined price. A combination of exit options and pre-emptive rights such as the right of first refusal, tag-along or drag-along rights, etc. is also preferred, as it also provides opportunity to the remaining shareholders to maintain the percentage of their ownership in the investee company.

In India, enforceability of options contracts and contractual restrictions in the form of pre-emptive rights, have always been a part of the debate and has seen its own vicissitude. Legal issues in relation to the enforceability of the aforesaid options can be discussed in terms of the provisions of Companies Act, 2013 ("CA 2013") along with its erstwhile Companies Act, 1956 (CA 1956) and notifications issued by the Securities and Exchange Board of India ("SEBI") which we will discuss briefly in this article.

FROM SEBI’S POINT OF VIEW

Earlier, there was no legislation for the regulation of stock exchanges until the Bombay Securities Contracts Control Act (“BSCCA”) was enacted in 1925 to regulate and control contracts for the purchase and sale of securities in the City of Bombay and elsewhere in the Bombay Presidency. However, BSCCA was replaced by the Securities Contracts Regulation Act (SCRA) in

1956, to provide for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges and to prevent undesirable transactions in securities. Thereafter, the SCRA became the primary regulatory body governing the validity of contracts for the sale and purchase of securities in India, including option contracts and contracts for pre-emption.

The SCRA vide notification in 1969 prohibited trading 'options in securities', though this notification was repealed in 2000 and another notification was issued on the same day but most of its parts were similar to that of 1969 notification. SEBI has always been of the view that privately contracted option are forward contracts as it allows the parties to exercise a right to put or call in future, which is illegal. According to SEBI, only spot delivery contracts are valid as the transfer of money and shares happens on the same day as the contract. However, SEBI has now permitted options and contracts for pre-emption in shareholders' agreements or Articles of Association of companies or other body corporate vide its notification dated 3rd October 2013, provided it is in accordance with the provisions of the Foreign Exchange Management Act, 1999 and rules or regulations made thereunder.

The Bombay High Court in Jethalal C. Thakkar Vs. R.N. Kapur decided in 1955 under the erstwhile BSCCA 1925, explained that according to the definition of ready delivery contract, no time must be specified for its performance as it needs to be performed immediately or within a reasonable time. Thus, if under the contract of purchase or sale of shares, there is no present obligation and the obligation arises because of some condition being complied with or some contingency occurring then the same is valid and enforceable. Hence, contracts can be considered within the definition and scope of ready delivery contract, because as soon as the obligation ripened, the contract was to be performed immediately or within a reasonable time. Thus, with regard to the private options contracts, it can always be argued that once the option is exercised, the contract is typically performed immediately, that is, on spot delivery basis and should be enforceable.

Even, under SCRA similar reasoning was given by The Bombay High Court in MCX Stock Exchange Limited Vs. Securities & Exchange Board of India in 2012. In the given case, an impugned order was passed by whole time member of SEBI where buyback agreement was being considered as forward contracts and thus contrary to the provisions under SCRA. However, the Bombay High Court explained that a buyback agreement confers an option on the promisee and no contract for the purchase and sale of shares is made until the option is exercised. The promisor cannot compel exercising of the option and if the promisee did not exercise the option in future, there would be no contract for the sale and purchase of shares. Once a contract is arrived at upon the option being exercised, the contract would be fulfilled by spot delivery and would, therefore, not be unlawful. This judgement clearly distinguishes a 'forward contract', which are prohibited under the SCRA, and options for sale/ purchase of securities and explains that the nature of an 'option' is that of a privilege and the conclusion of contract to purchase and sell securities comes during exercising the option.

However, the Supreme Court on SEBI's appeal through Special Leave Petition held that SEBI shall not be bound by any observations or comments made by the High Court in the impugned judgment for making amendments in the Regulation.

From The View Point Of Companies Act, 2013 ('CA 2013') And Its Erstwhile Companies Act, 1956 ('CA 1956')

As far as the new CA, 2013 and its erstwhile CA, 1956 is concerned; enforceability of options and pre-emption rights attracts various provisions like nature of shares, inconsistency of any provisions contained in any private agreement and articles of the company or provisions of CA, rectification of register of members, transferability of shares, restriction on transfer of shares by private companies, etc. The importance of interpretations of the above mentioned provisions can be seen through the judgements given in the following case laws.

In one of the landmark judgement VB Rangaraj v. VB Gopalakrishnan, where Supreme Court held that if shareholders agreement imposes any additional restrictions on transferability of shares that are contrary to the Articles of Association (AOA) of the company then Articles of Association will prevail. A big question was raised on the enforceability of private agreements between two or more shareholders and/or the company and will it be considered valid if the clauses pertaining such pre-emptive rights and or put and call options of private agreements are embodied in articles of the company.

In Mafatlal Industries Ltd. Vs. Gujarat Gas Co. Ltd. also, it was contended that free transferability of shares refers to absence of restrictions which may be imposed by third parties, but it cannot exclude the right of a shareholder to impose restrictions on himself in the matter of transfer of shares to another person. However, High Court of Gujarat relied on the judgement of the Apex Court given in VB Rangaraj v. VB Gopalakrishnan which held that agreement for pre-emption is not binding.

Thus, from aforementioned judgements, it can be stated that the restrictions on transferability of shares imposed by the shareholder on himself through private shareholders agreement stands nullified which is justified merely because they are not contained in Articles of Association of the company. If that is the case, then there is a big question on the enforceability of agreements such as security creation agreements with regard to the pledge of share wherein restrictions on its transferability is the essence of the agreement. And, if the shares pledged are of listed companies then is it possible to amend the Articles of Association of such company that consist of innumerable shareholders.

However, the decision held in M.S. Madhusoodhanan and Anr. Vs. Kerala Kaumudi Pvt. Ltd. and Ors., by the Apex Court is entirely distinguishable on facts which was held in Rangaraj and Mafatlal Industries Ltd. In the Karar (agreement) there is no such restriction on the transferability of shares as the agreement is between particular shareholders relating to the transfer of specified shares. It was also contended that the consensual agreement between two or more shareholders, is in relation to their own specified shares and in restriction of their own right to free transferability of shares held by them, which impose no restriction on the transferability of shares as specified under section 111A of the CA, 1956.

In Western Maharashtra Development Corpn. Ltd. Vs. Bajaj Auto Limited, the High Court of Bombay set aside the arbitral award in 2010 explaining that the Arbitrator fell into a patent illegality by proceeding on the basis that the presence of a clause conferring a right of pre-emption in the AOA was sufficient to dispose of the challenge regarding its legality. The Bombay High Court explained that, in case of private companies the Articles of Association would restrict the right of shareholders to transfer shares and prohibit invitation to the public to subscribe for shares or debentures of the Company. The position in law of a public company is materially different. By the provisions of the CA, 1956, restrictions on the transferability of shares which are contemplated by the definition of a "private company" under Section 3(1)(iii) are expressly made impermissible in the case of a public company by the provisions of Section 111A. Thus, a restriction to that effect cannot be read into the provision of Section 111A as it is not mentioned in the statutory provision and the word "transferable" is of utmost importance that should be given a wide connotation. Reference of Madhusoodhanan case was also given, where Supreme Court noted that the Karar was an agreement between "particular shareholders relating to the transfer of the specified shares" and does not impose any restriction on transferability of shares of the company.

Section 22A of the Securities Contracts (Regulation) Act, 1956 was removed by the Depositories Act, 1996 and simultaneously 111A of the CA, 1956 was introduced which is currently replaced with Section 59 of CA, 2013. Section 59 declares the shares of a company to be freely transferable. However, both the provisions regulates the power of the Board of Directors to refuse registration of shares and never intended to invalidate contractual restrictions or to affect the right of

shareholders to deal with their shares or to enter into any consensual agreement. The legislature intends to ensure that any refusal from the Board of Directors of the company for registration of transferee as shareholder is backed with a valid reason and not at the discretion of the board. The company or any other shareholder need not be a part of that agreement and for that same reason it need not be embedded in AOA of the company. However, as far as a private company is concerned, it is permitted to insert restrictions on transfer of shares in its articles with respect to provisions of Section 2(68) and Section 58(1) of CA, 2013. Thus, any restriction on transfer of shares or provision pertaining to call and put option as agreed under the consensual arrangement shall be valid. It shall be binding on such a private company and duly incorporated in the AOA, enforceable against the shareholders of a private company.

Vodafone International Holdings Vs Union of India and Anr.

In this case, Supreme Court perceived that all the provisions included in investment agreements regarding pre-emptions or call/ put options etc. may administer and regulate the rights between the parties. These rights should be purely contractual and should be owned by the parties. It was also stated that if mentioned in the Article of Association, then the shares can be freely transferred in any manner.

Nishkalp Investments and Trading Co. ltd vs Hinduja TMT Ltd.

In this case, Bombay High Court observed that a contingent contract is within the scope of SCRA and is also lawfully applicable under it. The problem with respect to this case was related to buy back agreement. In this case, there was repurchase of certain number of shares and these shares were unlisted on the stock exchanges by a certain agreed date.

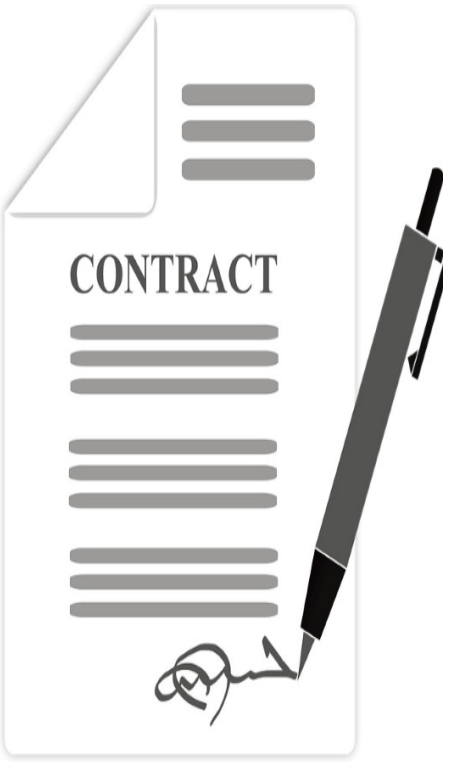
Bombay High Court concluded the contingent contract as invalid because the setup of buyback of shares as mentioned above, were not covered under the provisions of SCRA.

NTT Docomo Inc. v. Tata Sons Limited

The Delhi High Court examined the locus standi of the RBI to object to the enforcement of an award delivered in an arbitration between two private parties. Tata Sons and Docomo had entered into a shareholders' agreement in 2009 by way of which Docomo acquired a shareholding of 26% in TTSL, a joint venture between Tata Sons and Docomo. In terms of the shareholders' agreement, in the event TTSL failed to satisfy certain prescribed performance indicators, Tata Sons would be obligated to find a buyer for or acquire Docomo's shares in TTSL at the higher (a) fair value of the shares; or (b) 50% of the original investment amount.

Upon a failure on the part of Tata Sons to abide by the put obligation, Docomo invoked arbitration proceedings seated in London, and raised a claim for damages on account of breach of the representations made by Tata Sons under the shareholders' agreement. The arbitral tribunal found in favour of Docomo and ordered Tata Sons to pay Docomo an amount of USD 1,172,137,717. Docomo subsequently sought enforcement of the award before the Delhi High Court. While the enforcement was initially resisted by Tata Sons, the parties subsequently reached a settlement under which Tata Sons agreed to withdraw its objections to the enforcement.

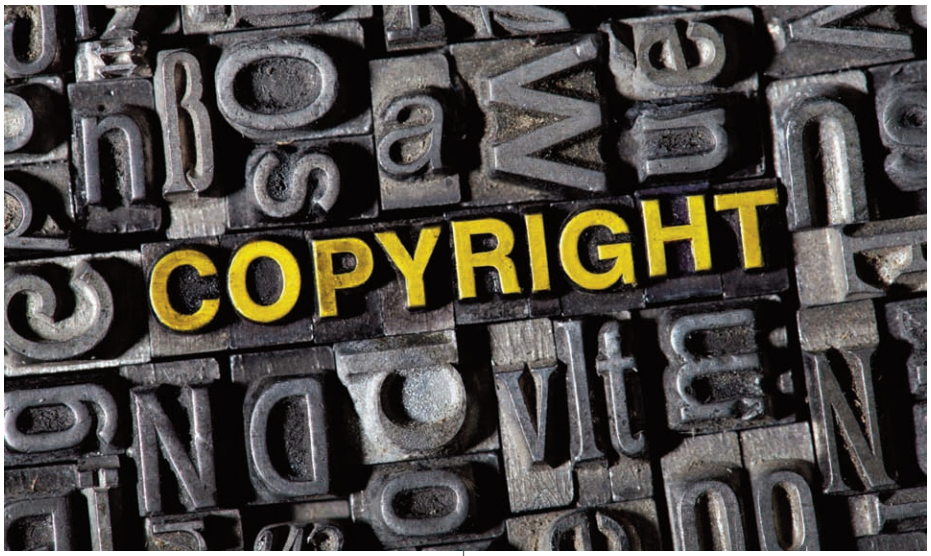
At this stage, the RBI filed an intervention plea before the High Court, and argued that regardless of the settlement arrived at between the parties, the impugned award was unenforceable by virtue of being illegal and contrary to the public policy of India on the basis of non-compliance with FEMA regulations.



Conclusion

After going through the conceptual understanding and interpretations of the court in the above mentioned judgements, it can be concluded that the enforceability of options contracts in case of private limited companies can be held valid merely because of the non-applicability of SCRA. However, in case of public limited companies due to the applicability of SCRA and multiplicity of judgements, it has added to the existing confusion and unless all the hurdles relating to enforceability of options is straightened out, these options may not be able to serve the purpose of the "exit options" as intended by the parties. Thus, considering the uncertainty, due thought and consideration need to be given while drafting the exit rights of any contract.

News Update



Copyright Office gets Review of Policy on Foreign Direct Investment (FDI) in e-commerce

The Government has reviewed the policy on Foreign Direct Investment (FDI) in the e-commerce sector. It will be effective from 1st February, 2019. To refer to the latest FDI press note, click here

Changes in SEBI's LODR (Sixth Amendment) Regulations, 2018

SEBI has notified amendments to LODR Regulations vide SEBI (Listing obligations and Disclosure Requirements) (Sixth Amendment) Regulations, 2018 dated 16th November, 2018.

Some of the major amendments that have been made in the regulations are:

- The provision for Disclosure of Class of shareholders, which was earlier captured under Regulation 31A has now been incorporated in Regulation 31 as sub-regulation 4.
- Regulation 31A (Disclosure of Class of shareholders and Conditions for Reclassification) has been substituted by a new provision 31A. Conditions for re-classification of any person as promoter / public.
- The substituted provision includes definitions of 'promoter seeking re-classification' and 'persons related to promoter seeking re-classification' bringing in more clarity with regard to re-classification.
- Every listed entity seeking re-classification of the status of any person must now make an application to the Stock exchange which would be decided upon by the stock exchange as against the earlier provision requiring the entities to make a request to the stock exchanges.
- Provisions for replacement of promoters and professionally managed promoters has been done away with and the regulation now defines listed entity with no promoters' as a listed entity which due to re-classification or otherwise, does not have any promoter.

The new regulation has entirely revised the procedure and conditions for reclassification. To read the LODR Regulation (Sixth Amendment) Regulations, 2018 click here

RBI amends Foreign Exchange Management (Deposit) Regulations, 2016

In order to assuage the regulatory requirement, the Reserve Bank of India has amended the Foreign Exchange Management (Deposit) Regulations, 2016 wherein new proviso has been inserted in Regulation 7 which explicates that an authorized dealer may allow Foreign Portfolio Investment (FPIs) and Foreign Venture Capital Investors to open and maintain a non-interest bearing foreign currency account for the purpose of making investment in accordance with FEMA regulations. These regulations may be called the Foreign Exchange Management (Deposit) (Amendment) Regulations, 2018. The amendment Regulations are effective from 9th November, 2018.

ECB Policy Liberalised for public sector Oil Marketing Companies

The Reserve Bank of India (RBI) has relaxed the policy regarding borrowing from overseas to allow state-owned fuel retailers to raise up to USD 10 billion external debt for working capital needs. Till now oil marketing companies were not allowed to raise External Commercial Borrowings (ECB) for working capital needs on a long-term basis. They could raise a maximum of a one-year overseas loan by way of buyers credit, repay it within 12 months and raise it again thereafter. Now, the RBI has allowed them to raise ECB of minimum maturity of 3 or 5 years. To read the RBI ECB Policy, click here

Making Headlines

THE ECONOMIC TIMES

IBC an imbalanced economic provision: Sanjay Singal

Dec 10, 2018 - Section 29(A) was also discussed at length in the October 4 Supreme Court judgement on Essar Steel, but in that case, the section itself had not been challenged and only the terms by way of which the two bidders – Arcelor-Mittal and Numetal – adhered to it were debated upon. "In the Supreme Court judgement on Essar Steel, it was assumed the section is constitutionally valid as it had not been challenged," said Alok Dhir, managing partner, Dhir & Dhir Associates.
The Economic Times

Essar Steel lenders back ArcelorMittal, file plan with NCLT

Oct 27, 2018 - The National Company Law Tribunal likely to hear matter after Diwali while Ruias weigh caveat option. "CoC has to respond within seven days on Essar's application filed under Section 12A," said Alok Dhir, managing partner of Dhir & Dhir Associates. ArcelorMittal said two-thirds of the transaction will be funded by debt and the rest through equity.
The Economic Times

Business Standard

London-based Liberty House fails to make the payment for Amtek Auto

Nov 23, 2018 -"This is a violation of an NCLT (National Company Law Tribunal) order. The banks are entitled to take action against the resolution applicant now as per the law," said Alok Dhir of Dhir & Dhir Associates. The bids will have to be called again or the company will be sent for liquidation. The company's liquidation value was Rs 40 billion.
Business Standard

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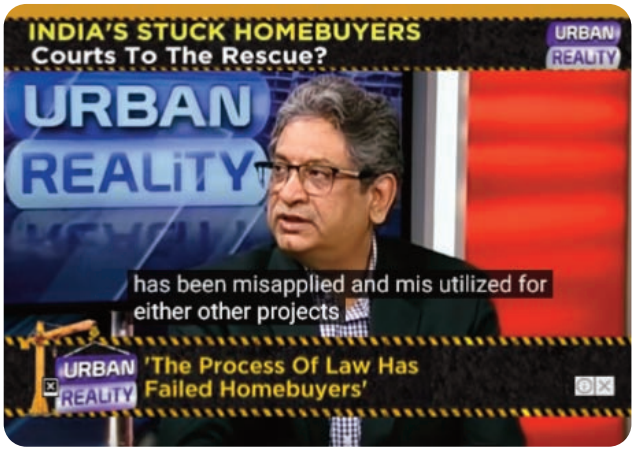
moneycontrol

Essar Steel bankruptcy: Standard Chartered Bank's petition raises transparency issue, says experts

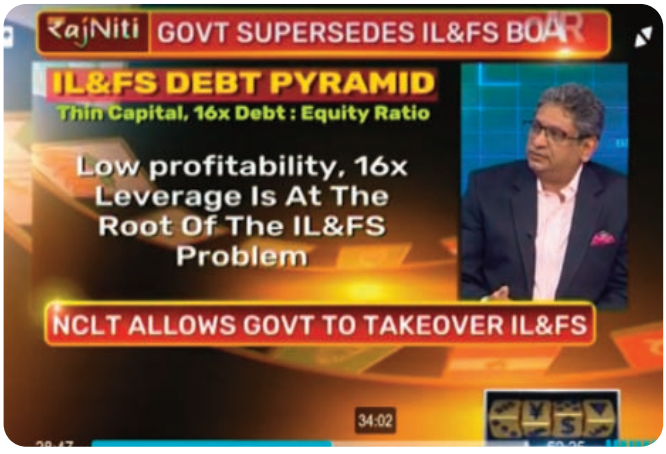
Nov 26, 2018 - The bank has accused the bigger financial creditors of undermining interest of their smaller peers. "These are serious allegations. There is no provision for a core committee under IBC. The petition highlights serious procedural issues," said Alok Dhir, an insolvency law expert and Managing Partner at Dhir & Dhir Associates.
Money Control

Electronic Media Coverages

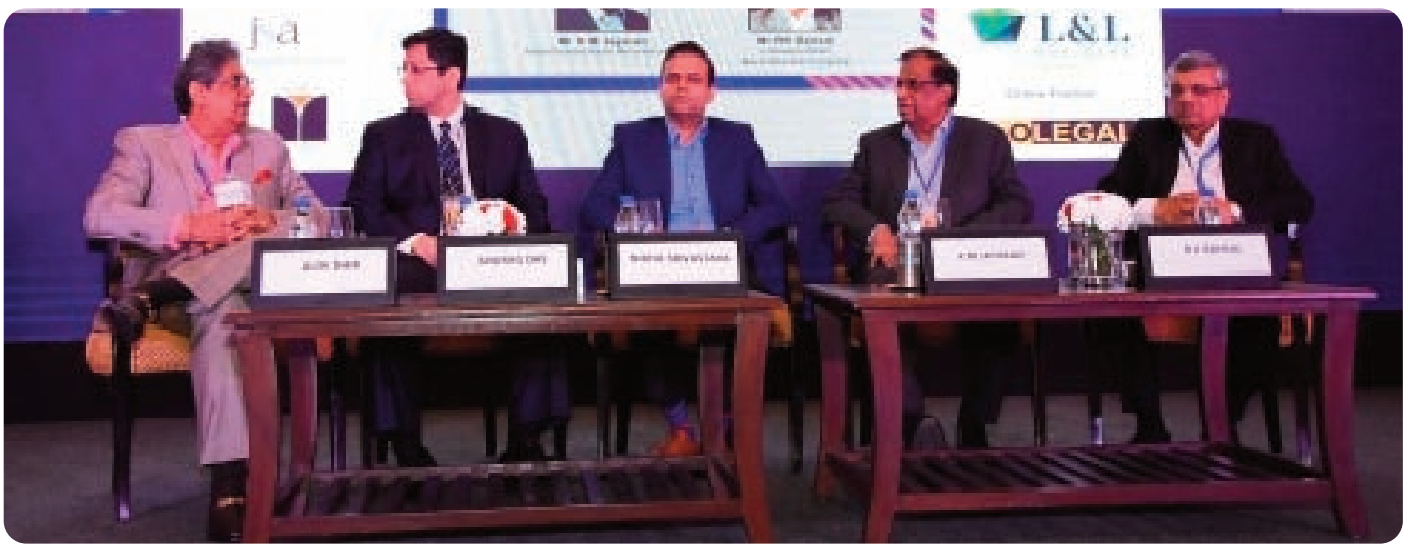
December 13, 2018 CNBC TV - Can India's courts rescue lakhs of stuck home buyers? CNBC TV18



October 01, 2018 BTVI - NCLT Allows Government to Takeover IL&FS BTVI



Notable Speakership



'The Stressed Asset Game is on - are funds ready to play?' held at The Leela Palace, New Delhi on 14th November, 2018 organised by Insol India

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