Escape legally

Put options are increasingly being used by jittery private equity investors looking for an exit in India. But are they legal?

With the resounding 'pop' of the global credit bubble, foreign investments in Indian companies are starting to dwindle and IPOs have disappeared. But aside from the apparent blow to the stock markets, there is also the problem of the millions of dollars that were invested by private equity funds in these companies in the hope of exiting through IPOs at favorable valuations. The definitive documents for such investments, in most cases a share subscription and shareholders agreement, typically provide for the investor's exit through an IPO. However, the agreement would also provide that if the investee company does not complete an IPO within the agreed time, the investor would have a so-called "buyback right" to cause the company to buy back its shares or a "put option right" to cause the management/ promoter of the company to purchase the investor's stake at an agreed return.

A buyback is subject to certain restrictions and must be compliant with several company law procedures and filings. But most importantly, even in cases where an investee company has the liquidity to buy out the investor, it can only use 25% of its paid up capital and free reserves to buy back the investor's shares. So a buyback right against the company alone may not suffice. A put option right against the promoter, either coupled with the buyback right or exercised independently, (subject to the promoter's liquidity) may be an alternative form of exit for an investor. This brings us to the legality of such exit rights and whether they are legally enforceable under Indian law.

At a glance

Private equity funds in India are trying to utilise their buyback right to cause targets to buy back their shares. They are also attempting to utilise their so-called put option right, to cause the management or promoter of the company to purchase their stake at an agreed return.

But there is debate over the legality of such exit rights and whether they are enforceable under Indian law.

All transactions in securities other than on a spot delivery basis or unless settled through the stock exchange are illegal. This begs the question of whether a put option is a forward contract and thus illegal.

Make the distinction

It is important to distinguish put options from options or futures contracts and other similar derivative contracts. The former merely gives a person an option to sell its shares at a later date for which consideration is paid only if and when the shares are eventually sold at the time of the sale. So there is no fixed commitment to sell shares. With respect to derivative contracts, their purpose is to trade in the underlying security where consideration is paid for the very grant of the option. As the legality of derivative contracts is well settled and provided for under relevant regulations, this article will deal with the former and not derivative contracts.

Until 1995, all options in securities - any contract for the purchase or sale of a right to buy and /or sell securities in future (including a put or call option) - were illegal. The prohibition on entering into such contracts was governed by Section 20 of the Securities Contract Regulation Act, 1956 (SCRA) called "Prohibition of Options in Securities". Additionally, a notification issued under the SCRA in 1969 provided that all contracts for the sale and purchase of securities other than so-called spot delivery contracts or contracts settled through the stock exchange were void. Spot delivery contracts are contracts which provide for delivery of securities and payment of the purchase price for such securities to take place on the same or next day.

The SCRA was amended in 1995 to remove the prohibition of options in securities, followed by the 1969 Notification being repealed in 2000. However, another notification was issued on the same day that the 1969 Notification was repealed and oddly, the 2000 Notification is largely similar to the 1969 Notification.

To sum up the law on this subject as it stands today, all transactions in securities other than on a spot delivery basis or unless settled through the stock exchange are illegal. This brings us to the main point of our discussion: is a put option a forward contract and thus illegal?

Jethalal case

To begin with, a put option may not even be treated as a completed contract as it is more like a contingent contract. It would result in a contract for sale or purchase of securities only upon exercise of the option and not merely upon the grant of such option. Further, once the option is exercised, the contract is typically performed immediately, on a spot

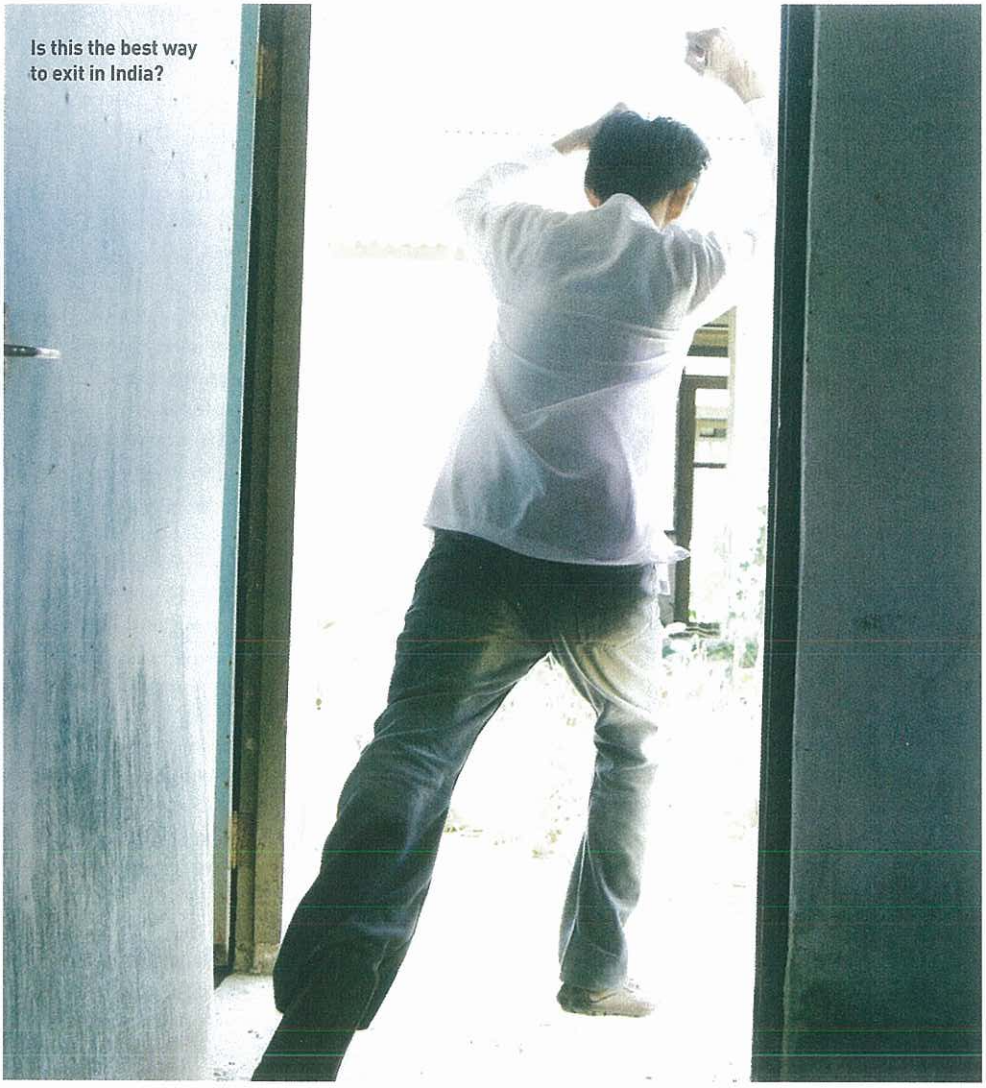
Is a put option a forward contract and thus illegal?

delivery basis where the consideration for the shares is paid at the same time as the transfer of such shares. This line of reasoning was adopted by the High Court of Bombay in the Jethalal case. Though the case examines the provisions of the erstwhile Bombay Securities Contracts Control Act, 1925 (SCCA) as was in existence prior to the enactment of the SCRA, given the similarity between the two enactments, the court's reasoning may nonetheless be appreciated. Akin to the spot delivery contract under the SCRA, the erstwhile SCCA dealt with a 'ready delivery contract' defined as a contract for the purchase or sale of securities for the performance of which no time is specified and which is to be performed immediately or within a reasonable time.

In the Jethalal case, the plaintiff and the defendant entered into an agreement where the defendant was to procure the sale of the plaintiff's shares at a certain price per share after 12 months contingent on the occurrence of certain events. It was also agreed that if at the end of twelve months, the defendant failed to procure a sale of the shares, the defendant would himself purchase the shares and pay the price at which they were agreed to be sold.

As the defendant failed to procure a sale of the shares within the time stipulated in the agreement, the plaintiff filed a suit against him claiming damages for breach of the agreement to purchase the shares himself. The defendant contended that the agreement in question did not satisfy the definition of a "ready delivery contract" under the SCCA and was thus void under Section 6 of the SCCA, while the plaintiff believed the contrary.

In this case, the court held that a clear distinction must be borne in mind between a case where there is a present obligation under a contract and the performance is postponed to a later date, and a case where there is no present obligation at all and the obligation arises by reason of some condition being complied with or some contingency occurring. The court held that as regards the contract entered into between the plaintiff and the defendant, at the date when the contract was entered into there was no present obligation with regard to the purchase or sale of the shares. The obligation undertaken by the defendant to purchase the shares only ripened into a perfect obligation at the end of the year when the contingency took place. Therefore, it is only at the end of the year that there was a contract of purchase or sale, and at the end of the year it is clear that the contract was to be performed immediately or within a reasonable time. The court thus held that the contract was valid and enforceable.


Is this the best way to exit in India?

The only defense available while seeking to enforce such exit rights would then be to restrict the scope and applicability of the SCRA

Exit rights should be structured so that once it becomes a contract (that is, upon the exercise of the put option), the parties should ensure that the consideration is paid and the securities are delivered either on the same day or the next day so as to bring it within the purview of a spot delivery contract, which is permissible under the SCRA. To be extra cautious, it is also advisable to structure put options and provide for such rights under the transaction documents such that it is abundantly clear that there is no fixed arrangement between the parties to buy/sell securities at a later date.

This has been the practice usually adopted by parties. However, a subsequent decision of the Bombay High court in *Niskalp Investments and Trading Co., v. Hinduja TMT* counters the principle laid out in the Jethalal case.

Hinduja Finance, one of the defendants, owned shares of Mody International Paper. The plaintiffs and Hinduja entered into a standard agreement in 1997 to provide for the plaintiff's purchase of shares of Mody from Hinduja.

Under the agreement, the plaintiff's exit

was to be provided by way of an IPO of Mody, failing which Hinduja was to buyback the plaintiff's stake at a 20% IRR on a spot delivery basis. Hinduja also has a general option to buyout the plaintiff at any time at an agreed price. As Mody did not complete the IPO and as Hinduja did not buyback the plaintiff's stake, it filed a suit for the recovery of the amount payable by Hinduja under the buyback/purchase arrangement. Hinduja contested the agreement as being void under the SCRA. The plaintiff relied on the Jethalal case to contend that the agreement in question is legal and enforceable. However, the court held that provisions of a spot delivery contract are *pari materia* different from the provisions of a ready delivery contract as provided under the SCCA. The court further held that an arrangement to buyback shares under a contract is not permissible and such an arrangement is hit by the provisions of the SCRA and thus void.

Gill & Co

The court appears to have reached such a conclusion solely on the basis of the Summons for Judgment 1997 in *Gill & Co. v. Inspat Finance & Another*. The court stated that the single judge in the Gill & Co case was considering an identical situation and by "considering all earlier judgments including the judgment of the apex court in *BOI Finance v. Custodian*", has come to the conclusion that the arrangement of buyback is contrary to the provision of the SCRA and is unenforceable in law.

However, the suit filed in the Gill & Co case was dismissed by the court on June 21 2005 for want of prosecution, as the parties had reached a settlement. Consequently the Summons for Judgment under the Gill & Co case, whatever the facts and circumstances or line of reasoning were, is no longer valid. Even though the Gill & Co case was dismissed on June 12 2005, the court appears to have relied on it when passing its judgment in the Hinduja Case on October 19 2005.

With respect to the BOI case, brokers were found to be entering into 'ready-forward contracts' (which are sometimes described as buy-back transactions) with various banks and financial institutions. These ready forward contracts essentially comprise of two interconnected legs; the first or the 'ready' leg for the sale of securities to banks, and the second or 'forward' leg for the repurchase of the securities from the banks within a fixed period (two to four weeks) for a fixed price. In the BOI case, the Supreme Court thus dealt with the illegality of buy-back transactions in the context of repo transactions and buy/sell transactions entered into by banks.

On a plain reading of the BOI case, it is clear that it deals with transactions altogether different from a put option exercisable by the option holder which entails the other party buying back or purchasing shares from such option holder contingent on the occurrence or non-occurrence of certain events at the option of the option holder.

So in reaching its fatal decision in the Hinduja case, the court has primarily relied on one case that had been dismissed and another that deals with fixed buy-sell arrangements by banks. In the Hinduja case, the reference to the plaintiff's put option against the seller (which became exercisable only if no IPO occurred) as a buyback arrangement, may have possibly led the court to construe such an arrangement as being similar to a buyback arrangement under the BOI case.

According to the courts, a market contemplates a free transaction where shares can be sold and purchased without any restriction as to title. The shares which are sold in a market must, therefore, have a high degree of liquidity by virtue of their character of free transferability. So marketability implies the ease of selling and includes any security which is capable of being sold in the market and does not necessarily entail only securities that are in actual fact sold on the stock exchange.

Consequently, as the shares of public companies are by their very nature freely transferable, the courts have held that the SCRA also applies to unlisted public limited companies. On the other hand, as shares of a private company do not possess the character of liquidity, in that it has the right to restrict the transfer of its shares, the SCRA may not apply to unlisted private limited companies.

According to the courts, a market contemplates a free transaction where shares can be sold and purchased without any restriction as to title

Don't scare them off

If the ruling of the Bombay High Court in the Hinduja case is not challenged, fairly customary albeit vital rights under shareholders agreements such as put option rights and rights to cause the company to buy-back its shares, even if settled on a spot delivery basis, would be regarded as unenforceable. Consequently, private equity players, many of whom have already quit given the current market scenario, would be hesitant to invest in India if their exit rights are not going to be enforceable.

The only defense available while seeking to enforce such exit rights would then be to restrict the scope and applicability of the SCRA.

The applicability of the SCRA has been settled through numerous judicial precedents. From the early 80's in *Dahiben Umedbhai Patel and Others v. Norman James Hamilton and Others*, to the more recent decision in *Mysore Fruit Products and Ors. v. The Custodian and Ors*, the view of the courts is that the SCRA applies not only to listed companies but also to an unlisted public company. The rationale for such a view is on the basis of the definition of securities under the SCRA, where the key criterion is that the securities are required to be 'marketable'.

Regardless of the principles outlined by the courts in determining the scope and ambit of the SCRA, the 2000 Notification and the SCRA would need to be read in conjunction. As the purpose of the 2000 Notification is to prevent undesirable speculation in securities, the provisions of the said Notification and the SCRA vis-à-vis forward contracts should extend solely to listed entities and not unlisted companies. Especially so as arrangements amongst shareholders of unlisted companies (whether private or public limited companies) cannot be regarded as having speculative elements. Further, even with respect to listed companies, so long as such put options granted by promoters or other shareholders of such listed companies, are settled on a 'spot delivery basis', they should be regarded as being enforceable. Necessary amendments to the SCRA or a clarifying circular to this effect by the Securities and Exchange Board of India would be most welcome, especially in these market conditions. Such changes would provide comfort to shareholders as regards the enforceability of their exit via put options – an increasingly popular form of exit.

By Archana Rajaram & Amrita Singh of Nishith Desai Associates