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# Options, puts and the law

Buy-back agreements between private equity investors and companies are fraught with legal complications

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With the resounding “pop” of the global credit bubble, the IPO bandwagon that Indian companies were once rushing to jump onto appears to have driven out of sight. The all too obvious brunt of the financial crisis aside, a consequential emerging issue is, what of the millions of dollars that were invested by private equity funds in these companies in the hope of exiting through IPOs at favourable valuations?

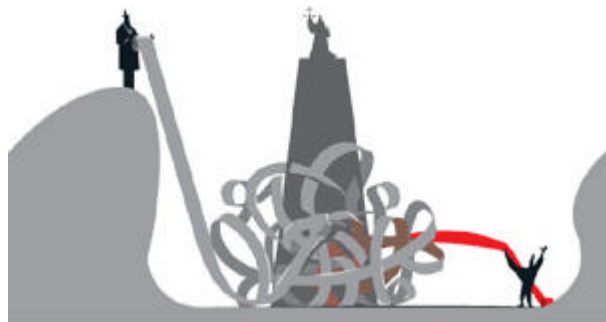


Illustration: Jayachandran / Mint

Typically as a fallback, the investor would have a “buy-back right” to cause the company to “buy back” its shares and/or a “put option right” to cause the management/promoters of the company to purchase its stake at an agreed return. But such seemingly standard exit rights

may not always be enforceable under Indian law.

After a notification issued in 1969 under the Securities Contracts Regulation Act (SCRA), 1956, all transactions in securities other than on a “spot delivery” basis or unless settled through the stock exchange are illegal. Though this notification was repealed in 2000, another notification was issued on the same day, which, oddly, was for the most part similar to the 1969 notification. “Spot delivery” basis, as the name suggests, are transactions where the transfer of securities and payment of consideration for such securities take place on the same or the next day. This brings us to the focal point of our discussion: Is a put option a spot delivery contract as is permissible under SCRA, or is it a forward contract and thus illegal?

To begin with, a put option may not even be treated as a completed contract as it is more in the nature of a contingent contract. It would result in a contract for sale or purchase of securities only upon the 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, that is, on a spot delivery basis and should thus be enforceable. This line of reasoning was accepted by the Bombay high court in a case decided under the erstwhile Bombay Securities Contracts Control Act (BSCCA), 1925, an enactment that is broadly similar to SCRA.

As long as put options are settled on a spot delivery basis, they should be enforceable

However, a recent decision of the Bombay high court in the *Niskalp Investments and Trading Co. Ltd v. Hinduja TMT Ltd* case in 2008 (Hinduja case) counters the above principle. In the Hinduja case, in accordance with the agreement executed between the parties for the purchase of securities, the purchaser was to be provided an exit by way of an IPO of the company, failing which the seller was to buy back the purchaser's stake at a 20% internal rate of return. The seller did not honour its obligations under the agreement and consequently, the purchaser approached the courts. However, the court held in favour of the seller, stating that the arrangement to buy back shares is hit by SCRA and is thus void.

The court appears to have reached such a conclusion solely by relying on a summons for judgement passed in 1997, which, in turn, had relied on a ruling passed by the Supreme Court. However, the suit filed in connection with the summons for judgement was dismissed in 2005 and consequently, had no bearing.

In its ruling, the Supreme Court had dealt with the illegality of ready-forward transactions (which are sometimes described as buy-back transactions) in the context of repo transactions and buy/sell transactions entered into by banks and financial institutions. Thus, in reaching its decision in the Hinduja case, the court primarily relied on one case that had been dismissed and another that deals with fixed buy-sell arrangements by banks, which are altogether different from the arrangement under the Hinduja case.

On the applicability of SCRA, given its objective (i.e., recognition of stock exchanges, conditions for listing and delisting of securities and so on), it should only apply to listed companies or companies that are about to list. However, the view of the courts under certain cases is that SCRA also applies to unlisted public companies (without any consideration of their intention to list).

The rationale for such a view rests on the basis of the definition of "securities" under SCRA, where the key criterion is that securities are required to be "marketable", a term that the courts have interpreted to be synonymous with "freely transferable". Unlike public companies, as private companies have the right to restrict the transfer of shares, such shares are not "freely transferable"/"marketable" and thus, private companies are fortunately outside the purview of SCRA.

Regardless of the applicability of SCRA, as long as put options are settled on a spot delivery basis, they should be enforceable. Necessary amendments to SCRA or a clarificatory circular by the Securities and Exchange Board of India to this effect would be useful, especially in the prevailing market conditions. Until such time, fairly customary, albeit vital, rights such as put option rights and rights to cause the company to buy back shares, even if settled on a spot delivery basis, may be regarded as being unenforceable, more so in light of the ruling in the Hinduja case.

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