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EXIT OPTIONS IN EQUITY INVESTMENTS IN INDIA: RECENT ISSUES ON LEGALITY

-Soma Bagaria
soma@vinodkothari.com

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It is common for an investor to secure its exit rights before making an investment. Typically, the exit mechanisms include an initial public offer (IPO), buy back of shares by the investee company and a put option and a call option or tag along / drag along rights. However, the foreign investments have taken a hit with the ongoing debate on the issue of enforceability of 'options' with no clarity on the same provided by the Indian regulatory authorities. This article seeks to analyse the issue of whether 'options', as an exit mechanism for private equity investors is enforceable under the Indian laws.

1. BACKGROUND

1.1 Meaning of put and call options

An option is a right or entitlement, but not an obligation, of a person to buy or sell, as the case may be, an underlying asset in future at a predetermined price. Such asset for our discussion purposes is 'shares'.

A **put option** is the right of a shareholder of a company to sell those shares to another existing shareholder at a specified price at the time such holder wishes to exit its investments in the investee company. Such other shareholder shall have an obligation to purchase those shares at the said predetermined price.

A **call option** grants a shareholder of a company the right to acquire shares in the company from another existing shareholder at a predetermined price. Such other shareholder shall have an obligation to sell the shares to the shareholder exercising his call option. To put it simply, call option is converse of a put option.

1.2 Use of call option and put option as exit mechanism for private equity investors

The exit provisions in a contract hold importance particularly in cases of foreign investment where the foreign investor seeks to ensure his exit rights vis-à-vis the investee company and other shareholders of the investee company. The investors primarily rely on the investee company floating their shares in an IPO, i.e. listing of shares, which provides liquidity and ample exit opportunities to the exiting shareholders. However, since listing of a company has various dimensions

attached to it which may not make listing a feasible exit mechanism, the investors fallback on other options for their exit.

For a foreign investor the aforesaid put option and call option hold different significance depending upon the strategy and the kind of investment:

(a) Call options (since provide a right to acquire more shares) are particularly useful to strategic investors in sectors having sectoral caps. This is because such investors take active interest in the functioning and operation of the company and spend considerable time, effort and resources in establishing the business of the investee company. Therefore, a call option gives them the right to acquire further shares in the event there is relaxation in the sectoral cap thereby enhancing the foreign shareholding limit. Typically, such option is of significance in a joint venture or acquisition transaction between Indian and foreign parties wherein the foreign investor is given a right to acquire shares from the Indian shareholders in case of increase in sectoral limit.

(b) Put options (since they provide a right to sell their shares) are useful for financial investors who make investments to reap benefits and earn profit from the investment, such investors primarily being private equity and venture capital investors. The put option may be vis-à-vis the investee company or the shareholders of the investee company. Since the company is subject to several regulatory restrictions when buying-back its own shares, typically the put option is obtained vis-à-vis the shareholders of the investee company.

1.3 The Debate

(a) Whether options are permissible in equity instruments under the foreign direct investments ("**FDI**") in India.

(b) Whether options contracts are valid and legal under the Securities Contracts (Regulation) Act, 1956 (the "**SCRA**").

(c) Whether options on shares of a public company and a private company are permissible under the Companies Act, 1956 (the "**Companies Act**").

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2. TREATMENT OF OPTIONS FOR FDI PURPOSES

2.1 Securities with Options Treated as Debt

Vide the FDI Policy (Circular 2 of 2011) dated September 30, 2011, which became effective from October 1, 2011 (the "**FDI Circular**"), the Department of Industrial Policy and Promotion from the Ministry of Commerce and Industry inserted a new clause 3.3.2.1 which provided that:

"Only equity shares, fully, compulsorily and mandatorily convertible debentures and fully, compulsorily and mandatorily convertible preference shares, *with no in-built options* of any type, would qualify as eligible instruments for FDI. Equity instruments issued/transferred to non-residents *having in-built options or supported by options sold by third parties would lose their equity character and such instruments would have to comply with the extant ECB guidelines*." [emphasis supplied]

Such a provision, in our view, was brought because of concerns of the Regulators that since options warranted safe exits, the foreign investors are not taking genuine equity risks in Indian companies and instead seeking an exit at guaranteed prices (which classifies such investment as debt). This raised a lot of criticism by the investors as such a provision affected genuine commercial transactions, where the foreign investor is provided an exit at the then prevailing fair market value (which, of course, would abide by the pricing norms). Also, in the sectors where external commercial borrowings ("**ECB**") are permitted, there was no reason as to why an investor would prefer to disguise its investment as equity.

Accordingly, by a recent amendment in *this provision was recently deleted from the FDI Circular*[1], which has been welcomed by the investors and joint venture partners and collaborators.

2.2 Status Quo maintained

[1] See Press Release on FDI Policy (Circular 2 of 2011) dated October 31, 2011.

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While a prima facie reading of the deletion of clause 3.3.2.1 may be interpreted to mean that options in equity instruments are now permissible. However, since it is unclear whether the deletion sets out a new policy or merely intends to maintain a status quo, ambiguity in the position still prevails and, thus, caution is imperative.

3. VALIDITY OF OPTIONS UNDER SCRA

3.1 Statutory Provisions

The SCRA was enacted with a primary intention of preventing undesirable transactions in securities. Post 1956, there has been a few amendments in the statue with a view to identify the contracts which would result in such undesirable transactions.

3.1.1 The Central Government has, in the interest of trade and commerce or the economic development of the country, the power under Section 28(2) of the SCRA to exempt a specified class of contracts from the purview of the SCRA. In exercise of such power, the Central Government vide its Notification No SO 1490 dated June 27, 1961[2], *specified contracts for pre-emption or similar rights contained in the promotion or collaboration agreements or in the articles of association of limited companies as contracts to which SCRA shall not apply*. No specific mention was made to options but a simple interpretation suggests options to be similar to 'pre-emption'. There was no discussion or issue regarding validity of options under SCRA at that stage.

3.1.2 Further, the Central Government vide its Notification dated June 27, 1969[3] under Section 16 (which empowers the Central Government to prohibit

[2] The relevant paragraph of the 1961 Notification is as follows:
"Whereas the Central Government is satisfied that in the interests of trade and commerce or the economic development of the country, it is necessary or expedient so to do; Now, therefore, in exercise of the powers conferred by sub-section (2) of section 28 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956), the Central Government hereby specifies *contracts for pre-emption or similar rights contained in the promotion or collaboration agreements or in the articles of association of limited companies* as contracts to which the said Act shall not apply". [emphasis supplied]

[3] The relevant paragraph of the 1991 Notification is as follows:
"In the territory to which the Act extends, no person can except with the permission of the Central Government enter into any contract for the sale or purchase of securities *other than such spot delivery*

certain contracts in specified securities in any state or area in India) of the SCRA prohibited all kinds of contracts except spot delivery contract[4] or contract for cash or hand delivery or special delivery in any security under SCRA. Any other contract could only be entered into with the permission of the Central Government. This Notification sought to restrict forward contracts. Forward contracts are over-the-counter derivative contracts by which one party agrees to deliver shares to another party on a predetermined date at a predetermined price. Unlike an option contract, a forward contract does not depend upon the exercise of an option by one of the parties.

3.1.3 Section 20[5] of the SCRA, which provided that all options in securities entered into after the commencement of SCRA or those entered before SCRA but remained to be performed were illegal. This *provision specifically prohibited options under SCRA. However, this provision was deleted by the Securities Laws (Amendment) Act, 1995* thereby leaving the issue for judicial interpretation. This has been the turning point which has triggered the debate.

3.1.4 In 2000, provision was inserted in SCRA providing that a derivative contract shall be invalid if they are settled outside the stock exchange.

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contract or contract for cash or hand delivery or special delivery in any security as is permissible under the Act and the Rules and bye-laws and the regulations of the recognised stock exchange". [emphasis supplied]

[4] Spot delivery contracts are those where the actual delivery of securities and the payment of a price occurs either on the same day of the contract or on the following day. Therefore, any contract entered into outside the stock exchange (such as an OTC transaction), where either the actual delivery of securities and payment of price is deferred beyond a day of the contract would be void.

[5] Section 20 of SCRA, prior to omission read as follows:

"Prohibition of options in securities – (1)Notwithstanding anything contained in this act or in other law for the time being in force, all options in securities entered into after the commencement of this act shall be illegal.

(2) Any option in securities which has been entered into before such commence and which remains to be performed, whether wholly or in part, after such commencement shall, to this extend, become void."

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3.1.5 Further, in 2000, the 1969 Notification was rescinded. However, SEBI vide its Notification No SO 184(E) dated 1 March 2000 issued directions having effect similar to that of the 1969 Notification.[6]

3.2 Whether options are derivatives

3.2.1 Section 2(ac) of the SCRA provides an inclusive definition of the term derivative which is stated to include:

(a) a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security;

(b) *a contract which derives its value from the prices, or index of prices, of underlying securities*.

3.2.2 In principle, the following four conditions have to be satisfied for a contract to be called a derivative:

(a) The value of which is derived from one or more underlying and the value of the derivative changes in response to changes in an 'underlying' price or index;

(b) Has one or more notional values;

(c) No actual delivery shall take place; and

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[6] "In exercise of the powers conferred by sub-section(1) of section 16 of the Securities Contracts (Regulation) Act, 1956…the Securities and Exchange Board of India (hereinafter referred to as "the Board") being of the opinion that it is necessary to prevent undesirable speculation in securities in the whole of India, hereby declares that no person in the territory to which the said Act extends, shall save with the permission of the Board, enter into any *contract for sale or purchase of securities other than such spot delivery contract or contract for cash or hand delivery or special delivery* in any securities or contract in derivatives as is permissible under the said Act or the Securities and Exchange Board of India Act, 1992 and the rules and regulations made under such Acts and the rules, bye-laws and regulations of a recognized stock exchange…" [emphasis supplied]

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(d) That requires little or no initial net investment (or significantly less than the investment required to purchase the underlying instrument); and

(e) That is net-settled at a future date.

3.2.3 Analysing the above conditions, it is clear that a contract to pay a certain amount at a later date on happening of a certain event, or a contract of sale / purchase at a later date at a predetermined price cannot be construed as a derivative. We are, therefore, of the opinion that a put and call option are not forms of derivative, and hence, it will not attract the provisions of SCRA in relation to derivatives.

3.3 Judicial Interpretations

3.3.1 In an early decision of the Division Bench of the Bombay High Court[7], a view was taken that the test to be applied to determine validity of a contract is:

(a) whether it is a contract for the purchase or sale of securities and whether it is to be performed within a specified time; or

(b) whether no time is specified in the contract and the contract is to be performed immediately or within a reasonable time.

The Division Bench also said that distinction must be made between a case where:

(a) there is a present obligation under a contract and the performance is postponed to a later date; and

(b) where there is no present obligation at all and the obligation arises by reason of some condition being complied with or some contingency occurring.

[7] *Jethalal C Thakkar v. RN Kapur* , AIR 1956 Bom 74

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If the contract falls under categories (b) of the preceding paragraphs then it is not a case where a present obligation is created and its performance is postponed.

3.3.2 The Supreme Court in the case of *BOI Finance Ltd. v. Custodian*[8], ruled that in case of a ready-forward contract, a ready leg (i.e. purchase or sale of securities at a stated price which in executed on payment of consideration for the spot delivery of the security certificates together with transfer forms) is valid and lawful but the forward leg (i.e. repurchase of the same securities on the later date at a specified price to be paid) is hit by the provisions of the SCRA and accordingly shall be ignored.

3.3.3 A view was taken by the Bombay High Court that a contingent contract is within the scope and applicability of the SCRA.[9] The question arose in the case of *Niskalp Investments and Trading Co. Ltd. v. Hinduja TMT Ltd*[10], where there was a buyback agreement to repurchase the certain specified shares if the shares were not listed on the stock exchange by a certain agreed date. In this case, the Bombay High Court held that a contingent contract for an arrangement of buyback of shares is hit by the provisions of the SCRA is in invalid in law.

3.3.4 It is to be noted that the rulings of respective Courts as stated above involved contracts for sale and purchase of securities and not 'options'. However, recently SEBI has in two cases involving shares of listed companies very clearly has been of the view that put and call options are invalid and unenforceable, and will not be given effect to by the regulator. One of such ruling was in relation to the public takeover of *Cairn India Limited* where the parties had entered into put and call options arrangements[11]. SEBI took a view that put option and call option arrangements and the right of first refusal do not conform to the requirements of a spot delivery contract nor with that of a contract of derivatives as provided under Section 18A of the SCRA and, therefore,

[8] [1997] 10 SCC 488, AIR 1997 SC 1952
[9] See *supra* note 8.
[10] [2008] 143 Comp. Cas. 204 (Bom). In this case the *BOI Finance case* was relied upon.
[11] *See* Letter of Offer to the Shareholders of Cairn India Limited. Copy of the Letter is available at http://www.sebi.gov.in/takeover/cairnlof.pdf (last visited on November 5, 2011).

SEBI the put and call option arrangement along with the right of first refusal are in illegal.

3.3.5 Further, SEBI provided an informal guidance to *Vulcan Engineers Limited* whereby it clearly stated that a pre-agreed buy-back of shares through put or call option is not valid under the SCRA.[12] The grounds on which this view was taken was the same as that in case of the public takeover of *Cairn India Limited*.

4. VALIDITY OF OPTIONS UNDER COMPANIES ACT

4.1 Before discussing the applicability of options under the Companies Act, let us revisit the kinds of companies thereunder and applicability of the SCRA to such companies:

4.1.1 Public companies

(i) Public listed company
(ii) Public unlisted company
(iii) Private company which is a subsidiary of a public company ("**Deemed Public Companies**")

4.1.2 Private Companies

4.2 *Public Companies*

4.2.1 Section 111A of the Companies Act provides for a free transferability of shares in case of a public company. While it is clear that the SCRA applies to public listed companies, its applicability in case of public unlisted companies has been strangely settled by judicial precedents. The Company Law Board in the case of *A.K. Menon v. Fairgrowth Financial Services Ltd*.[13] held that:

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[12] *See* the SEBI Letter dated May 23, 2011 addressed to Vulcan Engineers Ltd. Copy of the Letter is available at http://www.sebi.gov.in/informalguide/Vulcan/sebilettervulcan.pdf (last visited on November 5, 2011).
[13] [1994] 81 Comp Cas 508 (Bom)

(a) The SCRA and the 1969 Notification also relates to unlisted securities;

(b) A security which is marketable is covered by the SCRA;

(c) 'Marketable' would mean any security which is freely transferable;

(d) The SCRA provides for licensing of deals where there are no stock exchanges, there, can be concluded that the legislative intent was to extend applicability to the SCRA to unlisted securities.

4.2.2 In the *BOI Finance case*, there was no adjudication on the point of applicability of the SCRA to public unlisted companies, but the Supreme Court proceeded on the assumption of applicability of the SCRA.

4.2.3 Further, recently, SEBI in its *Order Disposing of the Application Dated April 7, 2010 Filed by MCX Stock Exchange Limited*[14] examined the applicability of the SCRA to unlisted securities. Relying upon the BOI Finance case and a decision of the Bombay High Court in case of *Mysore Fruit Products Ltd And Others v. The Custodian And Others*[15], SEBI held that it is a settled legal position that buy-back (forward contracts) arrangements in unlisted shares of public company are illegal under the SCRA.

4.2.4 Even under the provisions of the Companies Act, the Courts have taken a view that there can be no restriction on transferability of shares of a public company. In the case of *Western Maharashtra Development Corporation v. Bajaj Auto Limited*[16], the Bombay High Court has held that Section 111A of the Companies Act mandates that there can be no restriction whatsoever on the transferability of shares in a public company. Consequently, an agreement granting a right of pre-emption in respect of some such shares has been held as patently illegal. The Court further held

[14] A copy of the order is available at www.sebi.gov.in/cmorder/MCXExchange.pdf (last visited on November 5, 2011)

[15] (2005) 107 Bom LR 955

[16] Arbitration Petition No. 174 of 2006, decided on 15th February, 2010.

that the effect of a clause of pre-emption is to impose a restriction on the free transferability of the shares by subjecting the norms of transferability laid down in Section 111A to a pre-emptive right created by the agreement between the parties, which is impermissible.

4.2.5 Further, in the *Balco Arbitration Award*, the arbitration panel ruled that the call option was in violation of Section 111A(2) of the Companies Act.

4.2.6 However, a contrary view was taken by the Division Bench of the Bombay High Court in the case of *Messer Holdings Limited* v. *Shyam Madanmohan Ruia*[17]. The Division Bench held that a private arrangement between shareholders of a public limited company on a voluntary basis relating to share transfer restrictions (right of first refusal) is not violative of Section 111A of the Companies Act, 1956. The judgment also suggested that it is not mandatory for the Company to be a party to such an agreement relating to share transfer restrictions and it is not necessary to incorporate share transfer restrictions in the articles of association of the company.

4.2.7 Comfort maybe drawn from the fact that the position of restriction on transferability of shares of a public company by way of inter-se agreements has not yet been settled by the Supreme Court.

4.3 *Deemed Public Companies*

Since a Deemed Public Company and a private company have same provision applicable to in terms on restrictions on transfer of shares (and, therefore, on the non marketability of such shares), then unless otherwise construed by the courts, options in shares of a Deemed Public Company also should be valid and legal and not be affected by the provisions of SCRA and other notifications such as the 2000 Notification by SEBI.

4.4 *Private companies*

[17] Appeal No. 855 of 2003 in the High Court of Bombay.

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4.4.1 Section 3(iii) of the Companies Act defines private company to mean a company which by its Articles, restricts the right to transfer its shares, if any, and limits the number of its shares to 50 (excepting employees and ex-employees who were and are members of the company) and prohibits any invitation to the public to subscribe for any shares in, or debentures of, the company.

4.4.2 It is well known that unlike a private company, shares of a public company are freely transferable. Further, since SCRA deals with marketable securities, public listed companies directly come under the purview of SCRA. The implications under SCRA are discussed below separately. The question of applicability of SCRA to private companies was raised in the case of *Norman J Hamilton v. Umedbhai S. Patel*[18] where the Single Judge of the Bombay High Court took a view that the scheme of the SCRA was not intended to apply to the shares of a private limited company. The same was held on the following grounds:

(a) marketable security is one which enjoys a high degree of liquidity and can be readily sold in the market; and

(b) shares of a private limited company cannot be sold in the market;

The Division Bench upheld the above principle[19]. Hence, since private companies are outside the scope of SCRA, the restrictions on put and call options under SCRA are inapplicable to them.

4.4.3 However, it is pertinent to note the ruling of the Supreme Court to ensure applicability of restriction on transferability of shares of a private company. In the case of *V.B. Rangaraj v. V.B. Gopalakrishnan*[20], the Supreme Court held that a restriction to be binding on the company and the shareholders shall be specified in the articles of association of a company.

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[18] [1979] 49 Comp Cas 1 (Bom)

[19] *Dahiben Umedbhai Patel v. Norman J. Hamilton* [1985] 57 Comp Cas 700 (Bom) (DB).

[20] AIR 1992 SC 453, 1992 73 Comp Cas 201 (SC)

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5. ANALYSIS OF VALIDITY OF PUT AND CALL OPTIONS

The views of SEBI and Courts on enforceability of put and call options and pre-emption rights which are common to a joint venture agreement (particularly share purchase agreements) of companies which protect investor interest will have impact on the future of mergers and acquisitions public companies in India. However, in our opinion, there may be some grounds on which the views may be rebuttable:

5.1 Intention of Regulators and analysis of judicial precedents

The judicial precedents, except the recent SEBI orders in case of *Cairn India Limited* and *Vulcan Engineers*, have not dealt with "options in securities". All judgments in which the contracts were struck down as illegal, involved contracts for the sale or purchase of securities and not options in securities. The distinction between contracts for sale or purchase of securities and options in securities under SCRA was clear by express prohibition on options in securities under the erstwhile section 20 of the SCRA. This distinction was also recognized by the Division Bench of the Calcutta High Court in the matter of *East Indian Produce Ltd. v. Naresh Acharya Bhaduri*[21].

5.2 SCRA seeks to restrict undesirable speculation in securities

It has been specifically expressed intention of the Regulators to restrict forward contracts to prevent undesirable speculation in securities. Such speculation could normally occur only when the securities are frequently traded, which is not the case with unlisted securities where there is no market for trading. Therefore, keeping in mind the purpose and object of the 1969 Notification issued by the Central Government and the 2000 Notification issued by SEBI, it could be concluded that the applicability of the SCRA was limited to listed securities. Otherwise, even the genuine transactions, which are not speculative in nature (such as option arrangements), would be struck off.

5.3 Whether grant of options amount to a contract

[21] [1988]64 Comp Cas 259 (Cal)(DB)

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5.3.1 It may be argued that put and call option arrangements would become a contract for sale or purchase of securities only when the contingency (being the exercise of the put or call option) occurs and not merely by grant of such options. Therefore, only such arrangement becomes a contract (i.e. upon the exercise of the option), it is essential to be ensured that contract is a spot delivery contract, i.e. the payment of consideration and the delivery of securities is done either on the same day or the next day as required under the SCRA.

5.3.2 The above argument may be further justified on the following grounds:

(a) Under Section 31 of the Indian Contract Act, 1872 ("**Contract Act**"), a contingent contract is defined to be a contract to do or not to do something if some event collateral to such contract does or does not happen. Therefore, it may be argued that an option may not be a completed contract as it merely confers a right to sell or purchase securities and *may* result in a contract for sale or purchase or securities. Under Section 32 of the Contract Act, contracts which are contingent on the happening of a future uncertain event "cannot be enforced by law unless and until that event taken place.

(b) The High Court of Delhi in the case of *Union of India v. Bharat Engineering Corporation*[22] has held that a contingent contract is unenforceable until the condition on which it depends is fulfilled. Till then it is strictly not even a contract.

(c) Further comfort may be drawn from the Calcutta High Court ruling in the case of *East Indian Produce Ltd. v. Naresh Acharya Bhaduri*[23]wherein the Division Bench held that the restriction on spot delivery contracts applied to contracts for sale or purchase of securities and not options in securities which were separately prohibited under the erstwhile Section 20 of SCRA.

[22] ILR 1977 Delhi 57
[23] [1988]64 Comp. Cas. 259 (Cal)(DB)

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5.4 Exemption of collaboration agreements under the 1961 Notification

It may also be argued that option arrangements entered into between joint venture partners would fall within the exception provided under the 1961 Notification and therefore would be outside the ambit of the SCRA and consequently be legally valid. However, it may be noted that the exemption provided under the 1961 Notification is available only in limited circumstances.

6. CONCLUSION

It is pertinent to note that in 2010, India saw the largest increase in deal activity among the big Asia-Pacific markets which was more than double as compared to 2009 and was calculated at US$9.5 billion, including venture capital, infrastructure private equity investments and real estate investments.[24] For any such investments to be attracted to India and for India to continue with its growth by drawing foreign investors, it needs to provide such foreign investors with regulatory benefits. This is also because, exit is an important aspect of making an investment and forms a much negotiated and concerned clause under any Shareholders' Agreement and making these provisions impermissible at the outset would take out the substance of such an agreement.

We would like to highlight on the transactions where the foreign investors take the risk at the time of exit by agreeing to exit at the fair market value of the shares at the time of exit. If the intent of the put option is only to ensure the exit of a shareholder or section of shareholders, it is merely a matter of private treaty between shareholders. However, if a put option effectively works to guarantee a lender's rate of return to an investor, it has the effect of transforming an investment into a de facto loan, which may be defeating the distinction between FDI and ECB under foreign exchange regulations. However, to hold the very put option to be illegal may be anachronistic, as most derivatives are options, whether a put or a call option should not make any difference. Considering the spread and size of the global derivatives market, illegalizing options generically is like

[24] Source: India Private Equity Report, 2011. Copy of the same can be obtained at http://www.indiavca.org/IVCA%20Bain%20India%20Private%20Equity%20Report%202011.pdf. (last visited on November 5, 2011)

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tarnishing the whole derivatives market in one sweep. We would, therefore, rather contend that it is the use of options that may be challenged rather than put or call options per se.