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HUBTOWN CASE – REALISTIC INTERPRETATION OF ‘ASSURED RETURNS’ FROM A FEMA PERSPECTIVE

1. INTRODUCTION

The Supreme Court, in its judgment in *IDBI Trusteeship Ltd. V. Hubtown Ltd.*¹ on November 15, 2016, has set aside the Bombay High Court’s judgment (summarised below) regarding the validity of structured investments by foreign investors, where an assured return is guaranteed, holding a corporate guarantee for payments due to an investor, valid.

2. BRIEF FACTS

- 2.1 In 2009 and 2010, Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (“**FMO**”), a foreign investor, invested in an Indian company, Vinca Developer Pvt. Ltd. (“**Vinca**”) by way of: (i) equity shares, which entitled FMO to 10% voting rights in Vinca; and (ii) compulsorily convertible debentures (“**CCDs**”), which upon conversion, would entitle FMO to 99% voting rights in Vinca.
- 2.2 Vinca used these funds to invest in certain optionally partially convertible debentures (“**OPCDs**”) of Amazia Developers Pvt. Ltd. (“**Amazia**”) and Rubix Trading Pvt. Ltd. (“**Rubix**”). IDBI Trusteeship Pvt. Ltd. (“**IDBI**”) was appointed as the debenture trustee for the issue of OPCDs by Amazia and Rubix. IDBI stated that the funds from the issue of these OPCDs would be utilized by the companies for investing in real estate projects, which were compliant with the FDI Policy.
- 2.3 In order to secure the said OPCDs, and ensure due payment by Amazia and Rubix, Hubtown Ltd. (“**Hubtown**”), an entity which owns 49% voting on equity in Vinca, issued a corporate guarantee in favour of IDBI, amongst others, for the benefit of Vinca. Subsequently, both Amazia and Rubix defaulted on payments due under the OPCD trust deeds. IDBI therefore enforced the corporate guarantee and demanded payment from Hubtown with respect to the defaults. IDBI received no reply or payment from Hubtown in this regard, and so brought the matter to court.

3 LAWS APPLICABLE

- 3.1 The foreign exchange control laws in India, through the Foreign Exchange Management Act, 1999 (“**FEMA**”) and the regulations thereunder, along with the Foreign Direct Investment Policy (“**FDI Policy**”) in India, set out the instruments by which a foreign entity can invest in India, the kind of entities that can invest and receive investment, the caps applicable to certain sectors, and the modes and procedures relating to investment into the equity of an Indian entity.
- 3.2 The FDI Policy permits foreign direct investment into Indian entities only by way of equity instruments, or any instruments that are compulsorily convertible into equity. Investments that are *optionally convertible* into equity are not considered as

¹ Supreme Court, Civil Appeal No. 10860 of 2016.

FDI, and investments on the basis of fixed or assured returns, are not permitted. Further, FDI is not permitted in real estate sector, but it is allowed in projects related to townships, construction of houses, roads, bridges and other related infrastructure assets.

- 3.3 Under Order XXXVII Rule 3 of the Code of Civil Procedure, 1908 (the “CPC”), the conditions and principles governing leave to defend a summary suit are laid down. A landmark case regarding Order XXXVII Rule 3 of the CPC, as it stood prior to its amendment, was the Supreme Court’s judgment in *Mechelec Engineers and Manufacturers v. Basic Equipment Corporation*² (“**Mechelec’s case**”). After this provision in the CPC was amended, the Supreme Court’s verdict in *Milkhiram (India) Private Ltd. v. Chamanlal Brothers*³ (“**Milkhiram’s case**”), governed the interpretation of Order XXXVII Rule 3.

4 HIGH COURT’S JUDGMENT

Hubtown argued that FMO had knowingly devised this structure of investment to circumvent the FDI Policy, by routing funds downstream to Amazia and Rubix, after the primary investment in Vinca, which was the holding company for both Amazia and Rubix. Upon conversion of FMO’s CCDs into Vinca’s equity, FMO would receive certain fixed returns from the OPCD investment in Amazia and Rubix, when the payments were received by Vinca.

Hubtown argued that if the corporate guarantee were actually enforced, an illegal, impermissible investment structure would be effectuated. The Bombay High Court *prima facie* agreed with Hubtown, that the entire structure had been devised by FMO to bypass the FDI Policy, and was a colourable, illegal transaction, which could not be effected by enforcing Hubtown’s corporate guarantee. The Bombay High Court granted Hubtown unconditional leave to defend the suit. IDBI challenged this judgment of the Bombay High Court in the Supreme Court.

5. SUPREME COURT’S JUDGMENT

The Supreme Court, ruling in IDBI’s favour, held that Hubtown will be granted leave to defend the suit only upon (a) depositing the principal sum invested by FMO (amounting to INR 418 Crores) with the Bombay High Court; or (b) providing security for the said principal sum, within 3 months of the date of the Court’s decision. It further directed the expeditious trial of the suit at the Bombay High Court (preferably within the period of a year from the date of its judgment).

The Court’s observations and conclusions in this case are summarised below:

5.1 Alleged violation of FEMA

The Supreme Court remarked that FMO’s investment in the shares and CCDs issued by Vinca would by itself not violate FEMA regulations. This view of the Supreme Court appears to be driven by the fact that the suit has been filed only for the invocation of Hubtown’s corporate guarantee, at which stage there is no infraction of the foreign exchange laws of India (considering that the debenture trustee as well as the party on behalf of whom the payment is being made are both Indian companies). Further, the Supreme Court opined that it would not constitute a breach of FEMA regulations if FMO utilised the funds received pursuant to the overall structure agreements in India, upon conversion of the CCDs held by it in Vinca after the requisite time period.

² 1977 SCR (1)1060

³ AIR 1965 SC 1698

5.2 Position of law on Summary Procedure

The Supreme Court observed that the law, as it stands now, vests the discretion to refuse or grant the leave to defend under Order XXXVII of the CPC with the trial judge. In light of the amendment of Order XXXVII Rule 3, as well as the binding decision in Milkhiram's case, the Court laid down certain general principles in this regard (while superseding the principles stated in Mechelec's case). The principle most pertinent to this case was of Hubtown having raised a 'plausible but improbable' defence, and the Court thereafter imposed the deposit and security condition on Hubtown based on this defence.

IndusLaw View:

The decision of the Bombay High Court in this matter had previously created an element of uncertainty in the minds of foreign investors, since it appeared that guarantors could drag foreign investors to court, and deny the enforceability of their obligations under guarantees by alleging FEMA violations. There was also a feeling that FEMA provisions would now be liberally and holistically interpreted by the courts and not just the regulators.

However, the Supreme Court has given welcome guidance that if and when the monies are repatriated it is up to the RBI as the primary regulator to decide whether there was any violation of FEMA regulations and the court could not lightly take an 'indirect' approach to a contract that on the face of it did not involve a non-resident party and was therefore outside the ambit of FEMA. While avoiding a decision on merits, and leaving that to the trial court, the Supreme Court appears to have, *prima facie*, affirmed the structure in order to ensure that grounds of public policy do not facilitate injustice. This approach towards enforceability of rights is reassuring for foreign investors and their investees undertaking downstream transactions.

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