Enforceability of Options in Investment Agreements

Introduction

In the modern era investment agreements, inclusion of Options clauses has become customary. Investment agreements involving joint venture agreements, private equity and venture capital investments usually provide for "call" or "put" options to protect the interests of the parties.

Options are essentially of two types, namely, “put” and “call” options. **Options confer a right on the option holder, but not the obligation, to buy or sell an underlying asset (which is usually a stock or an index) at a predetermined price within a specified time**. Options are also treated as a form of derivatives as they derive their value from the underlying shares. It does not entail any obligation on the option holder to buy or sell the concerned stock and he can exercise this right at his option. To acquire an option, an option premium is to be paid.

A “put option” is the right of the holder to sell shares and a “call option” is the right of the holder to buy shares, at a predetermined price called the strike rate on or before a certain date. “Put options” are in the nature of exit rights, made available to private equity and venture capital investors in the Company. These exit right can be in the form of either “put option” on the company or “put option” on the shareholders. In case of put option on the company, the company has to buy-back the shares of the investor, once he exercises his option. But, buy-back of shares by the company is subjected to numerous restrictions and thus, investors prefer the second possibility. “Call options” are more prominent in cases of joint ventures between foreign and Indian companies where the investment by foreign investors is restricted, by law, upto a specified percentage of shares. In cases, “call option” can be exercised by the foreign investors, on their Indian partners to acquire beyond the prescribed investment caps when the law is amended to provide for enhanced shareholding. “Call options” are also found in acquisition transactions, where the acquirer retains a call option instead of acquiring all the shares in a single transaction.

Although, parties to various investment agreements lay down detailed clauses pertaining to options, enforceability of such options in case of listed companies, under Indian Law has been a constant subject of debate and the position is far from clear due to varying judicial interpretations and discrepancies in laws.

Arguments Against Enforceability of Options:-

1. An Option Contract is violative of the provisions of Securities Contract

Regulation Act, 1956 (“SCRA”)

The SCRA regulates contracts in securities of any incorporated company or any other body Corporate. Initially S. 20 of the SCRA declared ‘options in securities’ to be illegal. Also, the Preamble of SCRA contained words such as “prohibiting options” which out rightly invalidated any kind of options in contracts.

In the year 1961, the Central Government, in exercise of its power conferred under SCRA, issued a notification which states that pre-emption contracts or any other rights similar to the pre- emption contracts, contained in the promotion or collaboration agreements or in the Articles of Association of limited companies, would fall outside the purview of SCRA. Even though the option contracts are in the nature of the same rights as the pre-emption rights, it remained unclear whether this notification would apply to option contracts or not. Since S. 20 of SCRA was still in force, at the time of this notification, it may be construed that this notification would not apply to option contracts.

Further, in the year 1969, another notification was issued by the Central Government where under all contracts for sale or purchase of securities, other than “spot delivery contracts” or contracts settled through the stock exchange, were declared to be void. A “spot delivery contract” is a contract which provides for *“a) actual delivery of securities and payment of price therefore either on the same day as the date of the contract or the next day; b) or transfer of securities through a depository. This notification specifically ruled out the enforceability of options in contracts.”*

However, a remarkable step to uphold options came with the amendment made to the provisions of SCRA in 1995. The amendment not only omitted the words “by prohibiting options” from the Preamble but also omitted S. 20 of SCRA which declared options in securities to be illegal. This was followed by a further round of amendments in the year 2000 whereby S.18A was introduced into the SCRA which provide that, notwithstanding anything contained in any other law for the time being in force, derivatives contracts will be treated as legal, if they are traded and settled through the stock exchange.

Subsequently, in March 2000, following the trail of amendments, mentioned in the previous paragraph, the Central Government repealed the Notification of 1969. However, the SEBI issued a Notification on the same lines, as the 1969 notification. Thus, this SEBI Notification read with S. 18-A of the SCRA, creates a dubious situation for the enforceability of options, traded other than through stock exchange.

2. Options Impose Restrictions on Transferability of Shares :-

Another impediment for enforceability of Options is S. 111 A of the Companies Act, 1956, which provides that shares or debentures and any interest therein of a public company shall be freely transferable.

In the landmark case of *V.B. Rangaraj v. V. B. Gopalkrishnan*[1], the Supreme Court held that *"the restrictions on transfer of shares not contained in the Articles of Association of a Company would not bind the company or the shareholders"*. Later, in *Pushpa Katoch v. Manu Maharani Hotels Ltd*[2]., the Delhi High Court, while considering the validity of pre-emptive rights held that "*even if the pre- emptive right was included in the articles of association it would violate Section 111 A of the Act and would be ultra vires. It is argued that a call option acts as a restriction on the option seller's ability to transfer those shares of a company that form a part of the option".*

Analysis

The deletion of S. 20 followed by the repealing of Notification of 1969, expresses the legislative intent to validate option contracts. Further, the legislative intent behind the introduction of S. 18-A is to be considered. Since its introduction, S. 18-A has been interpreted to mean that, only exchange traded options were legal and enforceable. However, on the analysis of the circumstances which preceded the introduction of S. 18-A, it is clear that the concern of the legislature at the time was to ensure that the derivatives sought to be introduced by the amendment, do not qualify as wagering agreements under S. 30 of the Indian Contract Act, 1872. Thus, S. 18-A was introduced to avoid the possibility of such derivatives being declared as void on account of being 'wagers', and not to imply that only exchange traded options were legal.

It is pertinent to note that SEBI's notification in 2000, regulate only 'contract for the sale' or 'purchase of securities'. Options are mere contingent contracts and they become contracts for or relating to sale or purchase of securities, only in the event of the said option is exercised by the option holder; otherwise they are merely contingent contracts which do not come under the purview of the SCRA and the SEBI notification of 2000. This view was also taken by the Bombay High Court in*Jethalal C. Thakkar v. R.N. Kapur*[3], wherein whilst analyzing the validity of a contingent contract for sale and purchase of securities, the court held that the contingent contract did not fall within the ambit of the Bombay Act which (on similar lines with SCRA) provided that every contract for sale or purchase of securities, other than a ready delivery contract is void. But, in its subsequent judgement in*Niskalp Investments and Trading Co. Ltd. v. Hinduja TMT Ltd*., the Hon'ble Court did not accept the reasoning stated in the said *Jethalal's* case on the ground that the Bombay Act was not in *parimateria* to the SCRA.

Moreover, the call option does not impose a restriction on transferability of shares.

Since, a call option does not materialise into a contract for sale on purchase of securities, until the option is exercised, it does not prevent the option seller from transferring his shares. Thus, a call option *per se* without any express restriction on transfer, does not constitute a restriction on transfer of shares.

SEBI's Clarifications:

Lately, SEBI's pronouncements have made its stance clearer to not to recognize options. In 2010, in an application filed by MCX Stock Exchange Limited, SEBI held forward contracts in general to be illegal even in public limited companies that were not listed on any stock exchange. Later, in 2011, SEBI vide its letter, in connection with the put and call options entered into by parties in relation to public takeover of Cairn India Limited, stated that such put and call options were violative of SCRA. Also, when an informal guidance was sought from the SEBI by Vulcan Engineers Limited, SEBI ruled that the put and call options, entered into by parties did not qualify as a spot delivery contract (as required by SEBI regulations) and being traded privately between the parties and not through the stock exchange, were not valid under the SCRA.

Recent Development

Options are important structuring tools for mobilising investment. There has been a constant demand to bring out clarity in their enforceability. In a major development this month, the law ministry has approved the proposal to allow put and call options in share purchase agreements. The proposal will now go for the approval of the Finance Ministry and if approved, then an amendment will be made to the SEBI regulations to provide that these options are valid and enforceable.

The proposal is welcomed by the industry as it is expected to promote foreign investments in India. This will bring clarity to the Private Equity Investors who will be able to enforce options with complete certainty even in the public companies. The decision will allow the funds to exit from the investee companies. Allowing the options would enable the private equity investors with appropriate exit rights, thereby, giving a boost to foreign investments in India.

1. (1992) 1 SCC 160.
2. (2006) 131 Comp Cas 42 (Delhi).
3. AIR 1956 Bom 74.

Another shot in the arm for arbitration in India

The Hon'ble Supreme of India in its recent decision in *Antrix Corp. Ltd. v. Devas Multimedia P. Ltd*[4] has yet again paved a way for minimal interference with the Arbitration process by the Courts.

The issue before the Supreme Court was, whether S. 11 of the Arbitration And Conciliation Act, 1996 ("**Act**") for constituting the Arbitral tribunal in respect of a particular dispute, can be invoked when the ICC Rules had already been invoked one of the parties.

The Supreme Court whilst deciding the above issue relied upon the judgment of the Punjab and Haryana High Court in the case of *Som Datt Builders Pvt. Ltd. v. State of Punjab*[5],wherein it was held that, once an Arbitral Tribunal is a seized of the disputes between the parties to the arbitration agreement, the constitution of another arbitral tribunal in respect of those same issues would be without jurisdiction.

The Supreme Court affirming the view of the Punjab and Haryana High Court stated that the dissatisfied or the aggrieved party is free to challenge the appointment of the arbitrator in accordance with S. 13 of the Act and thereafter under S. 34 of the Act. However, the same could not be done under S. 11(6) of the Act and seek the appointment of another Arbitral Tribunal, thus, narrowing the scope of S. 11 (6) of the Act.

This Judgments paves way for a pro-arbitration atmosphere in India and discourage the courts, to the extent possible, from interfering with the arbitration process.

4. Arbitration Petition No. 20 of 2011 decided on 10.05.2013.
5. AIR 2006 P&H 124

TRAI amends Customer Preference Regulations

The Telecom Commercial Communications Customer Preference (Twelfth Amendment) Regulations, 2013 has been issued by the Telecom Regulatory Authority of India ("**TRAI**") in order to further tighten the regulatory framework, especially relating to commercial communication from subscribers indulging in telemarketing activities, deliberately masquerading themselves, without registering as a telemarketer with TRAI. These subscribers indulge in such activities without paying promotional SMS charge or any other charges as may be payable by registered telemarketers. The said regulations is available at

http://trai.gov.in/RegulationUser.aspx?qid=0&id=0

Clarifications by SEBI on Schemes of Arrangements

SEBI, by way of another circular dated May 21, 2013, has clarified some of the outstanding issues and also made some modifications to the previous circular on schemes of arrangement under the Companies Act, 1956. There are amendments to the applicability of the circular and majority requirements in voting. The said circular is available at

Jurisdiction to determine the claim of the Workmen

The question, whether the claims of the workmen who claimed to be entitled to payment paripassu have to be considered by the official liquidator or whether their claims have to be adjudicated upon by the Debts Recovery Tribunal ("**DRT**"), is likely to arise in a large number of cases where recoveries are sought to be made pursuant to the certificates issued by the DRT.

When the debtor company is in liquidation, the dues of workmen can only be determined by the official liquidator including the extent of the deemed charge and the limits. The DRT has neither the competence nor the machinery to adjudicate upon or decide dues of the workmen of the debtor company; since, the official liquidator represents the entire body of creditors and also holds a right on behalf of the workmen to have a distribution paripassu with the secured creditors.

In *Bank of Maharashtra v. Pandurang Keshav Gorwardkar & Ors*, Civil Appeal No. 7045 of 2005 and Civil Appeal No. 7046 of 2005, the Supreme Court held that the claims of the workmen who claim to be entitled to payment paripassu have to be considered and adjudicated by the liquidator of the debtor company and not by the DRT.

In view of the aforesaid premised reasons, the appeal, being devoid of merit, stands dismissed.

News 10 @ a glance

Supreme Court on withdrawal of Takeover Offer

In an appeal by Nirma Industries Limited against SAT's order, Supreme Court has rejected Nirma's plea to withdraw the open offer for the shares of SRMTL. Nirma sought to withdraw the offer as allegedly, the promoters of Rama Multi-Tech had siphoned off funds from the company and the fact came to light only at a later stage. The court largely relying on Regulation 27 of SEBI Takeover

Regulations, which allows withdrawal of offer only if statutory approvals required have been refused or the sole acquirer, being a natural person has died, concluded that withdrawal in the given circumstances was not permissible.

Clarified Scheme of Arrangements

SEBI vide Circular dated May 21, 2013 has clarified the issues regarding its Regulation on scheme of arrangement date February 3, 2013. By the said Circular, the SEBI has widened the scope of the Regulation by including all scheme of arrangements, irrespective of the fact whether exemption under Rule 19(7) of SCR Rule, 1957, has been requested or not. Further to facilitate the applicant,75% voting requirements has been limited to related party transactions in a more stringent manner. In addition, SEBI has also limited the filing of report by independent CA only where there is change in shareholding of the company.

Hyperactive CCI

CCI has been into constant probe on matters relating to anti-competitive matters. Recently, it has submitted its report on the anti-competitive actions of some majors in Indian DTH services like Dish TV, Reliance Big, Tata Sky and Sun Direct, for not complying with Regulations. Further CCI has also reported the alleged loan prepayment charges being levied by the banks. CCI has also been given a free hand in probing the alliance between the Kingfisher and Jet airlines.

FRAND now a detailed guideline for fixing royalty

By supplementing India's first FRAND case of *Ericsson v. Micromax*, the US court in its 207 pages judgment in the case of*Microsoft v. Motorola*, has laid down a firm and detailed guideline for fixing of royalty in the form of FRAND (fair, reasonable and non-discriminatory), and commented extensively on Patent Hold-up and Royalty Stacking.

Interim order against Hindustan Unilever Ltd

In a suit filed by Reckitt Benckiser against the Hindustan Unilever Ltd. ("**HUL**") for disparaging advertisement, the Delhi High Court has granted an interim injunction against HUL. Reckitt alleged that HUL maliciously equated plaintiff's product "Dettol Healthy Kitchen" to a Harsh Antiseptic while advertising its product Vim Liquid. The Court held that the advertisement gave an impression to the consumers that Dettol's healthy kitchen had the same ingredients as Dettol's antiseptic liquid and thus, passed an interim order restraining the defendant from publishing the impugned advertisement.

Delhi High Court on Comparative Advertising

The Delhi HC in the matter of*Safolla Gold v. Fortune Refine*, rejected the appeal for interim injunction by taking the ground that, "*the law is that any trader is entitled to puff his own goods even though such puff as a matter of pure logic involves the denigration of his rival's goods. Notices reading "the best tailor in the world*", "*the best tailor in this town"* and the *"best tailor in this street "do not commit an actionable offence*".

New Guidelines for issue of equity shares against pre-incorporation expenses

The RBI vide its Circular dated 17th May, 2013, has amended the condition relating to issue of equity shares, by companies incorporated by foreign investors, against pre-incorporation expenses. As per the revised condition, payments by a foreign investor should be made to the Company directly or through the bank account, opened by the foreign investor, as provided under FEMA Regulations.

Vodafone can now go for tax conciliation

The Law Ministry, has now agreed to resolve the Vodafone tax liability dispute through 'Conciliation'. After receiving Finance Ministry's clarifications on this, Attorney General, GE Vahanvati, has also given his assent to the proposal. Under the proposal, any Conciliation the Finance Ministry arrives at with Vodafone will have to be cleared by the Cabinet. After approval from the Cabinet, the proposal will have to be ratified by Parliament.

SC refuses to impose a complete ban on arrests under IT Act

In the Writ Petition, filed for a complete ban on arrests under S. 66A of the Information Technology Act, 2000, under which one Ms. Vindhyala was arrested for posting on Facebook derogatory comments a Congress MLA, the Supreme Court refused to slap blanket ban on the arrest of a person for making objectionable comments on websites. However, it ruled that no person should be arrested for posting objectionable comments on social networking sites, without permission from senior police officers.

Tax Residency Certificate provision removed

The proposed Tax Residency Certificate Provision in the Finance Bill, 2013 which sought to provide that a TRC even if in a prescribed format would only be a necessary, but not sufficient condition for claiming benefits under the Tax Treaties, has been removed by the Finance Ministry. The change was brought about after considering the foreign investor's concerns. Consequently, a TRC issued by any foreign government as per its domestic laws will suffice for claiming benefits under Double Taxation Avoidance Agreements.