

Enforcement of Foreign Awards granting a Put Option despite objections under the FEMA

INTRODUCTION

A 'put option' is a clause agreed in a contract whereby one party has the right (not an obligation) to sell its shares in a company to another person at an agreed price. Such price need not be an absolute number recorded in the contract and could be in the form of an agreed formula or may be left to determination by an expert (pre-agreed or subject to future agreement) using financial data as of an agreed date. A put option works as a means of exit for investor shareholders. Subject to a valid exercise of the put option and correctness of the valuation, once a put option is exercised, it entails a contractual obligation on the party upon which such option is exercised to purchase the shares at such price and acquire the shares.

In India, foreign investors rely on put options to exit the investee company while protecting the value of their investment, given that an initial public offering is not always feasible, liquidation or voluntary winding-up proceedings may be too time consuming and an obligation on the investee company to buy-back their shares may be met with strict and cumbersome regulatory procedures. This article seeks to briefly discuss the treatment of objections to enforcement of foreign awards on grounds that the put option clause granted through the foreign award violates the foreign exchange laws of India.

FOREIGN EXCHANGE LAW IN INDIA

The law relating to foreign exchange was consolidated in the Foreign Exchange and Management Act, 1999 ("FEMA") with the objective of, *inter-alia*, facilitating external trade and payments. The FEMA repealed the Foreign Exchange Regulation Act, 1973 ("FERA"), which as the name suggests was concerned more with the regulation of all foreign exchange transactions. Pursuant to powers under the FEMA, the Reserve

Bank of India (“**RBI**”) introduced the Foreign Exchange Management (Transfer or issue of Security by a Person Resident outside India) Regulations, 2000 (“**FEMA-20**”) to prohibit, restrict or regulate, transfer or issue of securities by a person resident outside India. These regulations were replaced by the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017 (“**FEMA-20R**”) and have now been superseded by the newly introduced Foreign Exchange Management (Non-debt Instruments) Rules, 2019 (“**Non-debt Rules**”).

FEMA-20 made no mention of the permissibility of put option clauses, which are in the nature of an optionality clause, in investment agreements for investments made by a person resident outside India. The RBI by way of a notification dated November 12, 2013 provided that *“shares or convertible debentures containing an optionality clause but without any option/right to exit at an assured price shall be reckoned as eligible instruments to be issued to a person resident outside India by an Indian company subject to the terms and conditions as specified in Schedule I.”* This was followed by a RBI circular dated January 9, 2014 which, in dealing with optionality clauses (either a put option or a call option) expressly stated that *“optionality clauses may henceforth be allowed in equity shares and compulsorily and mandatorily convertible preference shares/debentures to be issued to a person resident outside India under the Foreign Direct Investment (FDI) Scheme. The optionality clause will oblige the buy-back of securities from the investor at the price prevailing/value determined at the time of exercise of the optionality so as to enable the investor to exit without any assured return.”* An optionality clause, including a put option clause would also be subject to other conditions laid out in such circular. Subsequently, by way of a circular dated July 15, 2014, the RBI revised the pricing guidelines applicable to issue and transfer of shares having optionality clauses. The exercise of a put option would therefore be subject to these revised pricing guidelines.

Further to the aforesaid notification and circulars, Regulation 10(7) of the FEMA-20R recognized the permissibility of put option clauses subject to (i) exercise of such option not resulting in any assured return; (ii) pricing guidelines provided in the regulations; and (iii) lock-in requirements prescribed by the regulations. This provision has also been incorporated in the Non-debt Rules. The pricing guidelines state that the transfer of shares of an unlisted company from a person resident outside India to a person resident in India shall be at a value not exceeding the valuation of the capital instrument in accordance with any internationally accepted pricing methodology for valuation on an arm’s length basis duly certified by a chartered accountant or a Securities and Exchange Board of India registered Merchant Banker or a practicing cost accountant.

In view of the above, foreign investors are often faced with the argument that the exercise of their put option constitutes an assured exit and if the transfer is to be made at a price above the fair market value of such shares, then, that such transfer would be in violation of the statutory pricing guidelines.

JUDICIAL PRECEDENTS

While pleadings and submissions made by parties before arbitral tribunals including in relation to violation of the FEMA are not available publicly due to the confidential nature of arbitration proceedings, such pleadings and submissions are discernible from decisions passed by Indian courts in enforcement proceedings.

At first, it is essential to note that a foreign arbitration award may not be enforced under Section 48 of the Arbitration Act on the ground, *inter-alia*, that such foreign award is contrary to the public policy of India. While courts were earlier inclined to consider the ground of 'patent illegality' as falling within the scope of 'public policy', after the amendment to the Arbitration Act in 2015, the scope of enquiry in relation to public policy has been limited to: (i) fraud or corruption or violation of sections 75 or 81 of the Arbitration Act; (ii) conflict with the most basic notions of morality or justice; and (iii) contravention of the fundamental policy of Indian law which does not result in review of the dispute on merits. In the year before the aforesaid amendment, the Supreme Court had in *Shree Lal Mahal Ltd. v. Progetto Grano SPA* ((2014) 2 SCC 433) clarified that a mere contravention of law would not attract the bar of public policy.

Given below is a brief of the circumstances and reasons for which awards granted in favor of foreign investors granting put option clauses have been upheld:

- a. In *NTT Docomo Inc. ("Docomo") v. Tata Sons Limited*, (2017(4) ARBLR 127 (Delhi)) the arbitral tribunal had observed that there were modes of performance of the put option obligation that would not require any special permission from the RBI. The Delhi High Court also observed that the clause in the investment agreement protected Docomo from not losing more than 50% of its investment and was in the nature of downside protection not amounting to an assured return. Eventually, the arbitral tribunal held that there was a breach of a contractual obligation to find an alternative buyer that entitled Docomo to damages and accordingly, awarded the claim amount in the nature of damages as opposed to sale consideration for the transfer of the shares by Docomo. The Delhi High Court while upholding such award indicated that since the arbitral award contemplated payment for damages instead of enforcing the put option there is no violation of the FEMA. On similar lines, the Delhi High Court in *Shakti Nath and others v. Alpha Tiger Cyprus Investment No.3 Ltd. and others* (2017(5) ARBLR 112 (Delhi)) held

that enforcement of an award awarding damages resulting from the breach of a put option would not violate any FEMA or RBI guidelines. The issue of whether an award directing the specific performance of a put option would be enforced by a court in India was not addressed directly in these decisions.

- b. In *Cruz City1 Mauritius Holdings v. Unitech Ltd.*(2017(3) ARBLR 20 (Delhi)) the dispute arose out of a 'Keepwell Agreement' and a shareholders agreement pursuant to which the petitioner exercised a put option, due to delay in commencement of construction of a real estate project. While recognizing that Section 48 of the Arbitration Act was enacted to give effect to Article V of the New York Convention, the Delhi High Court observed that enforcement of an award on grounds of public policy provides the strongest expression of a sovereign's reservation that its executive power shall not be used to enforce a foreign award which is in conflict with its policy. Further, public policy considerations are to be balanced and courts need to consider whether refusal to enforce the foreign award might be more offensive to the public policy. The court referred to various Indian and foreign decisions to conclude that the width of the public policy defense to resist enforcement of a foreign award is extremely narrow and after considering the material change in fundamental policy of exchange control as evolved from the FERA to the FEMA, concluded that violations of FEMA would not warrant a challenge to the enforcement of foreign arbitral awards on public policy grounds. The court gave importance to the possibility of compounding such irregularities and even seeking *ex post facto* permission from the RBI to come to such conclusion.

Further, the Delhi High Court held that it would not be open to the respondent to raise a plea that the investment by the petitioner was in violation of the FEMA or that performance of its contractual obligations was impermissible under the FEMA, given that the respondents had provided extensive representations and warranties that its obligations under the transaction documents were legally valid and binding¹. Lastly, the court refused to accept that the put option clause amounted to an assured return as it was not an open ended exit option. The put option was exercisable within a specified time and was contingent on construction of the real estate project not commencing within the agreed timelines. The Delhi High Court also observed that the above referenced RBI circulars proscribe assured return on investments in India under the guise of equity, but would not apply to cases where the foreign investor exercises a put option as a remedy pursuant to a breach of

¹ Interestingly the Delhi High Court also relied upon the notes to the financial statements forming part of the annual returns filed by Unitech to determine if the arguments advanced by Unitech were an afterthought and *malafide* in nature.

contract. A special leave petition filed before the Supreme Court against this decision of the Delhi High Court was dismissed.²

- c. The Supreme Court also approved the aforesaid view of the Delhi High Court in *Vijay Karia and others v. Prysmian Cavi E Sistemi SRL and others* (2020(1) ARBLR 474 (SC)) wherein a foreign award requiring transfer of securities from an Indian resident to a person resident outside India at a price below the fair market value was upheld and contentions that enforcement of such award would be in violation of the FEMA and therefore, the public policy of India, were dismissed. In this light, the determination of a challenge to enforceability of a foreign arbitral award on the ground that the underlying contract or the award itself violates provisions of the FEMA is no longer *res integra*. Further, on the basis of the judgment it may be argued that the Supreme Court in upholding the foreign award, which directed the resident respondents in the arbitration proceedings to transfer the shares held by them in the Indian company to the foreign claimant at the discounted price, has gone a step further than the previous referred decisions by specifically enforcing the contractually agreed put-option clause despite the argument that such transfer would be in violation of the FEMA.
- d. The Bombay High Court recently, in *Banyan Tree Growth Capital LLC v. Axiom Cordages Ltd.*³ held that a put option providing exit to a foreign investor which is triggered in the event that the promoters of the investee company are unable to conduct an IPO or merger of the investee company, would not amount to an assured exit. Further, the put option deed under the relevant transaction documents provided that if the put option price (providing for a yield on 15% basis) was more than the fair market value of the securities to be transferred, the excess amount would be repatriated to the foreign investor's nominee's account in India. The court relying on the approval of a similar structure by the Supreme Court in *IDBI Trusteeship Services Ltd v. Hubtown Ltd.* (2018 SCC OnLine SC 2795) observed that there was no infraction of the FEMA. The court also recognized that the provisions of the FEMA, unlike its predecessor, do not seek to void a transaction but only regulate and manage foreign exchange remittance to a foreign country. Therefore, nothing in the FEMA could render the put option deed unenforceable and a violation of the provisions of the FEMA certainly cannot be reason for refusing enforcement of foreign awards on public policy grounds. The Bombay High Court

² Order dated January 19, 2018 in petition(s) for Special Leave to Appeal C No. 32244/2017 with SLP(C) Diary No. 2039/2018

³ Judgment dated April 30, 2020 in Commercial Arbitration Petition No. 476 of 2019

relied heavily on the decisions in *Vijay Karia* and *Cruz City* in arriving at such conclusion.

CONCLUSION

Courts in India have favored enforcement of arbitral awards honoring put option clauses, notwithstanding a possible violation of the pricing guidelines under the FEMA, provided that the put option is triggered by a contractual default. Such exercise of a put option at a fixed price is not seen as an assured exit by the courts. It is also refreshing to note that Indian courts have given importance to the representations and warranties made by the parties while entering into a commercial transaction and they are not inclined to simply enforce the provisions of foreign exchange laws in India without giving due regard to the intention of parties providing such representations and warranties.

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