VALIDITY OF OPTIONS CONTRACTS IN INDIA – CASE COMMENT ON NTT DOCOMO INC V. TATA SONS LTD

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Abstract

Options contracts, although an attractive pick for foreign investors, have been viewed with utmost skepticism by regulatory bodies in India. Through the course of the paper, the author will be exploring the history of options contracts in India supported by relevant judgments and circulars, the recently concluded Tata-Docomo case, the relevance of S. 48 of the Arbitration and Conciliation Act, 1996 and will finally conclude with an analysis on whether the Supreme Court's decision is a boon or bane to India as a destination for foreign investment.

CYNICISM OF OPTIONS CONTRACTS IN INDIA

Options contracts have always been a bone of contention in the history of financial derivates in India. Simply put, an option contract is a financial derivative that represents a contract sold from one party to another. It entails the right, but not the obligation, to buy (call) or sell (put) a security or other financial asset based upon an agreed upon price (strike price) during a certain period of time or on a specific date (exercise date). There are three bodies in India that govern the usage of options contracts – the Securities and Exchange Board of India ("SEBI"), the Reserve Bank of India ("RBI") and the Ministry of Corporate Affairs. SEBI has historically objected to option contracts as a valid form of moulding financial transactions between parties as being in contravention of the Securities Contracts (Regulation) Act, 1956 ("SCRA") which permits only spot delivery contracts. This can be seen in a host of cases such as the Cairn and Vedanta Merger, the Diageo and United Spirits Merger as well as in an informal opinion to Vulcan Engineers Limited, where SEBI had asked the parties to delete the options clauses in their agreements as it was not in the nature of a spot delivery contract. Further, such options would not qualify as a legal and valid derivative contract in terms of S. 18A of the SCRA as it is exclusively entered between two parties privately and is not a contract traded on stock exchanges, further settled on the clearing house of the recognized stock exchange. However, SEBI gradually relaxed its position with a notification on October 3, 2013 granting validity to call and put options subject to certain conditions which are:

a) the selling party must mandatorily have both title and ownership of the securities for a period of one year continuously from the date of entering into the contract;
b) the price of the securities is determined in accordance with all the laws for the time being in force;
c) the contract has to be settled by way of actual delivery of the underlying securities.

Next, to understand the RBI's rationale, it is imperative to understand the difference in nature between a debt instrument and an equity instrument. An equity instrument inherently carries an element of risk with it as there is no set return on investment. However, a debt instrument is devoid of this element of risk as there is an assured return on the investment. According to the FDI Policy (Circular 2 of 2011), options to third parties would lose this equity (risk) character and would take the nature of a debt instrument; hence to be regulated by External

Commercial Borrowings Guidelines. The RBI has also been dubious about the genuineness of foreign investors as they were not taking risks in Indian companies and instead seeking an exit at guaranteed prices. However, an FDI Policy Circular subsequently permitted trading of options provided: a) There is a minimum lock-in period of one year or a minimum lock-in period as prescribed under FDI Regulations, whichever is higher (The Lock-in Period shall be calculated from allotment date of such securities) and b) Buy-back of securities to be at a prevailing price or at a value determined at the time of exercise of such an option.

TATA-DOCOMO CASE – A BOON OR A BANE TO INDIA'S FOREIGN INVESTMENT RELATIONS?

In March 2009, Docomo bought a 26.5% stake, valued at $2.6 billion, of Tata Teleservices. The shareholder's agreement signed between the parties had a put option which gave Docomo the right to sell its stake at fair value, or half the acquisition price, whichever is higher. With the venture not being very lucrative, Docomo wished to exercise its option in July 2014 and exit the investment. Upon exercise of the option, Docomo was entitled to Rs. 7,250 Crore which was half the cost of acquisition. Subsequently, Tata Sons deposited the amount due with the Delhi High Court, on the pre-condition that Indian laws permit them to pay the same. In January 2015, Docomo filed suit at the London Court of International Arbitration ("LCIA") following which, court ordered Tata Sons to pay $1.17 billion to Docomo for breach of contract and in exchange for which Docomo would hand back their shares in Tata Teleservices. In January 2014, as mentioned above, the RBI came with new norms that specified that foreign companies can only exit investments at a valuation based on the return on equity. Thus, RBI turned down Tata Sons' request to buy back Docomo's shares at half the amount the paid to the former in 2009, as part of the options agreement. The RBI said that the LCIA award is contrary to India's public policy stated under the Arbitration and Conciliation Act, 1996 and, therefore, cannot be enforced.

S. 48 OF ARBITRATION AND CONCILIATION ACT, 1996

In the field of Private International Law, courts refuse to recognize a foreign judgment or foreign arbitral award if it is found contrary to public policy of the country in which it is sought to be invoked or enforced. According to S. 34 and S. 48 of the Arbitration and Conciliation Act, 1996 courts can set aside an award if it finds it is in conflict with the public policy of India and it is for the court to test if the award is contrary to the fundamental policy of India. The former section is used in the context of domestic awards and the latter for foreign awards. The concept of "public policy" has been described as wild horse that has the ability to either take one to his destination or wreak havoc. The Supreme Court in Gherumal Parakh v. Mahadeodass Maiya also warned that in the interest of stability of society, new heads under the concept of public policy must not be made. The central government has defined the expression "public policy" as principles in accordance with which action of men and commodities need to be regulated to achieve the good of the entire community or public. The landmark case of Renusagar Power Co. Ltd. v. General Electric CO. discusses this point in much detail and held that mere contravention of law would not attract a bar of public policy. The award must be contrary to (i) fundamental policy of Indian Law, or (ii) the interests of India, or (iii) justice or morality. The moot question at hand is whether the concept of "public policy" under S. 34 and S. 48 of the Act could be read to mean "economic policy" of the country However, in the Renusagar case itself, the Court's decision was contrary to the rationale it expunged and held that a violation of the Foreign Exchange Regulation Act, 1973 ("FERA") was grave enough to constitute public policy contravention as the Act was enacted to preserve something as vital as India's foreign exchange interests and is no ordinary law. In C.O.S.I.D. Inc v. Steel Authority of India, SAIL could not discharge its contractual obligations towards COSID, a foreign company, due to an order passed by the Ministry of Iron and Steel. The Delhi High Court held that the order was in light of preserving economic interests of India and hence, the award was set aside effectively holding that public policy of the country could also include economic policy. However, in the more recently concluded case of Cruz City 1 Mauritius Holdings v. Unitech Limited, the court seems to have deviated from the Renusagar case and held a contravention of specific provisions of Foreign Exchange Management Act, 1999 was a scant defence to convince the court that public policy had been contravened. Unlike FERA, the contravention of which renders any transaction completely invalid, FEMA permits foreign

exchange transactions on a case by case basis subject to certain approvals by the central bank. The Court also held that the requirement for a regulator's approval is not sufficient to restrict enforceability.

ANALYSIS - PUBLIC POLICY V. DAMAGES FOR BREACH?

Contentiously, the court in the Cruz City case held that if the foreign investor seeks to exercise the option as damages for breach of contract, the RBI circulars that impede the usage of optionality clauses granting assured returns would not be applicable. In the Cruz City case, an amount equal to the option clause as calculated on the date of payment was to be paid as a result of breach of the Keepwell Agreement. If an investment is made on the basis of certain conditions, the investor would be entitled to damages if the terms were not adhered to. This was also followed up by the court in the Tata-Docomo case wherein it granted damages to Docomo on ground of contractual breach for failure to find a buyer at any price, including a price above the shares' market value.

The courts while doing so seem to tread a dangerous path by circumventing the provisions of any statute simply when the party effectively claims the same under the aegis of damages for breach. Thus, the purpose of the FEMA, which is to regulate foreign exchange in India is rendered nugatory when the parties can get their claims under damages. The court, although while holding that FEMA Rules and damages for contractual breach are two different compartments which cannot be compared, they effectively place damages for breach above truly adhering to the letter of the law. Thus, while the Tata-Docomo case may be a win for foreign investors, it has definitely diminished the sanctity of Indian laws. In the author's opinion, the damages doled out for breach of contract must not be done with a complete blind eye to the flagrant violation of laws as collateral damage.