Webinar

Exit Masterclass Series: Put Options and Buybacks

A Three-Session Series on Private Equity Exits In India and Some Pitfalls

Key Takeaways

- The tribunals are enforcing puts, and Indian courts are upholding those awards as not contrary to the fundamental policy of Indian law
- How the award is framed matters. A damages/money award can be treated as a current account transaction (no RBI permission needed); specific performance may face some challenges if the RBI does not permit. There are still ways to solve this problem through drafting
- "Assured return" is not fatal by itself. Structured as a consequence of default with a negotiated price, even a 25-30% return has been read as a negotiated outcome, not a guaranteed one
- Draft the put so a promoter nominee or third party can perform – a non-resident-to-non-resident transfer sidesteps the FEMA question entirely
- Puts go to dispute far more than buybacks: a put is a contract binding the promoter/third party, while a buyback is corporate-law-driven and capped by statute
- Use SIAC's PPO / emergency arbitrator when you fear shares or assets may move. Order can be passed within 24 hours, with a 3-day window to hear the other side

We are pleased to bring you Session 1 of the Exit Masterclass Series, in which specialists from Resolüt Partners, Freshfields and the Singapore International Arbitration Centre (SIAC) break down how Indian courts and tribunals are now enforcing put options and buybacks in PE exit disputes.

Recent Supreme Court judgments upholding SIAC arbitral awards on investor-exit matters have set a new high-water mark for investor protection in India. This session traces the arc from the RBI's historic hostility to optionality clauses, through Docomo and Cruz City, to the most recent Nine Rivers decision.

Cases discussed:
https://resolutpartners.com/events/webinar-exit-masterclass-series#relevant-judgements

Speakers

Pratibha Jain: Group General Counsel & Head of Strategy, Everstone Group

Rohit Bhat: Partner, Freshfields

Shwetha Bidhuri: Director & Head (South Asia), Singapore International Arbitration Centre

Ashish Kabra: Partner, Head – International Disputes & Investigations, Resolüt Partners

Mohammad Kamran: Partner – International Disputes & Investigations, Resolüt Partners

Transcript

Q: Why is put option the most disputed exit right in Indian PE?

Ashish: In the early 2000s, around the mid-2000s, puts were quite common. At that time, a promoter called RBI, saying that these options changed the nature of the instrument from equity to debt. Lo and behold, what followed was RBI saying that these clauses were not valid, and it started taking action in fact, preventing some investors from invoking these clauses.

We saw an early example in the D.E. Shaw case, where D.E. Shaw was prevented from enforcing its put option against DLF. And I've been told that the joke at the time was that when an investor "puts," the promoter "calls" that is, RBI. What followed was RBI issuing multiple notifications and circulars to the effect that optionality clauses with assured returns are not permitted, and, equally, promoters defaulting on contracts they had willingly signed, relying on the RBI notifications (among other things) to argue that these puts with assured returns are not enforceable.

Q: How did the approach change since 2017?

Ashish: Since 2017, we've seen the judgments in Docomo and Cruz City come in, and from there on a series of judgments have followed, most recently the Nine Rivers case, wherein the courts have upheld and enforced some of these clauses.

Q: What is the most preferred exit route for PE investors in India right now?

Pratibha: As financial investors, we invest with a very definite time period within which we have to exit.

So the exit rights need to be very tight and that's where the put comes into the thought process of the rights you consider as a lawyer. But top of mind for everybody right now are IPOs. The Indian IPO market has done well in recent times.

That's where the focus for all private equity investors has been in recent years if you can get that done. We all start working, as soon as we invest, to look at what the exit strategy vis-à-vis an IPO would be. And if the IPO doesn't work, the best option is a strategic sale to another PE fund or a strategic investor but basically a secondary sale to one of our peers. That has traditionally worked well too, and it's top of mind for everybody.

Q: Which sectors are more likely to have a put option?

Pratibha: I think real industries versus tech is the main differentiator I'd point to. And let me also say, puts are not something we rely on because we are control investors. I think it's more a tool for minority investors. When you're in control, unless the promoter intends to stay on, we're usually giving the promoter an exit and then just keeping them on for their expertise.

So it doesn't really work commercially in that scenario. Also, in tech, for example, the promoters are a little more uncertain and the business itself is a little more uncertain future projections, valuations, and cash flow are all issues, versus in real industries: heavy industries, infrastructure.You want to have more structured company cash flows there. And the promoter, if he really wants you out, can actually cough up the money, so it makes more sense. Typically in those scenarios of course, every company and every negotiation is different.

Q: Evolution of put options and other exit rights

Rohit: I think there's an increasing trend for financial sponsors. We're doing controlled deals, so we're seeing fewer contentious issues around exit rights than I was maybe five or six years ago. I used to see a lot of drag-along, tag-along, and then failure to have an IPO. Now the IPO market's pretty frothy, I guess, but we'll see. So there isn't a need to enforce them thankfully, they've reduced. But that doesn't mean these cases go away as we're seeing in the Supreme Court and the High Courts.

Pratibha: Rohit, there are cycles. Wait for the market to cool off a little and they'll all come back, unfortunately.

Rohit: Exactly.

Q: Do put options actually hold up before tribunals and Indian courts?

Rohit: Tribunals are enforcing these puts and a very clear trend that we've seen over the past ten years or so. I think, starting with Tata Docomo, and even before that, there are two ways to do it: one is damages, and the other is specific performance of the put directly enforcing the put itself. On damages, the tribunal turns the put into a money award. That's what happened in Docomo. The same happened in EIG v. McNally. The latest case this past year has been Nagaraj Mylandla, I think, where again it was enforced as damages. This distinction is quite important from a FEMA perspective, and in terms of how the court views this.

But I think the clear trend is that all of these tribunals are enforcing it. The next clear trend is that these tribunal enforcements are being challenged in court on the ground of FEMA violations. And then there's another clear trend: the courts are all upholding these awards on the ground that they do not violate FEMA, because it is not a fundamental violation of Indian public policy.

They say that whether RBI permission is needed or not is a separate question. That's where it gets really interesting. What the courts have been doing on multiple occasions is some courts have said RBI permission is not required, but I think most courts don't go into that question at all. They say RBI permission is a separate issue for the RBI: the court will either enforce the award as damages or grant specific performance.

Q: Damages or specific performance: does the label on the award decide whether you get paid?

Rohit: I want to deal with two cases. One, is the Nine Rivers case, which is the most recent, and interestingly it was a specific performance case specific performance was granted. The Delhi High Court upheld the award and said there was no violation of the fundamental policy of Indian law. It went to the Supreme Court, and in the Supreme Court, an RBI affidavit was placed on record.

The affidavit said that even though the Delhi High Court had held this was not an assured return that it was, in fact, a negotiated outcome because it was a consequence of breach. The RBI took the view that it did consider this an assured return, and that even if the award were enforced, since it viewed it as an assured return, permission would not be forthcoming.

The Supreme Court dismissed the appeal, upheld the award, and held that there was no breach of public policy. I don't know where that went to given the RBI's affidavit, you may have better clarity but that's a case where specific performance was granted. And if the RBI then went ahead and didn't give permission for the transfer of shares, the investor might have been left without a remedy.

Now take a different case one of the other lines of cases where damages were awarded instead. If damages are awarded, there's no question of specific performance; there's a separate question of what happens to the shares, which we'll come to later. But where damages are awarded, the RBI has filed an affidavit in one of these cases stating that it's a current account transaction, and therefore the investor doesn't need permission.

That seems to be the RBI's view is before the Supreme Court. But I think the distinction becomes clear in cases where the tribunals award it as damages it then becomes enforceable. The assured-return problem still exists, but it's perhaps less of a problem than when it's awarded as specific performance.

Q: When is a 25% IRR put not an assured return?

Rohit: What is the objective of the put is, and how it's going to be enforced? I think Nine Rivers dealt with this very specifically: is the put operating as an assured return i.e., is it a guaranteed return that can be exercised at any given point in time or is it an event-of-default put, where you then negotiate a price, leading to a negotiated outcome?

If you take that latter view the party has to do steps A, B, and C, and if they default on A, B, or C, you move to step D, which is the put, a consequence of that default then the price you negotiate for the put, even if it works out to an assured return of 25%, 30%, or whatever it is, becomes a negotiated outcome.

And, therefore, it's not an assured return. That's really the line of jurisprudence we're seeing a lot of courts holding that this isn't an assured return at all, starting with Docomo. They say it's a negotiated outcome, an event-of-default put mechanism, and you don't even need to get into the assured-return. But then you come back to the tension you just mentioned. If the RBI is treating it as an assured return, how do you resolve that conflict when there's a court judgment saying that's not an assured return.

Q: Can one drafting tweak take FEMA out of your put option?

Ashish: The other way we've often seen tribunals reason this out is by identifying that the put obligation isn't purely on the promoter, but extends to any nominee of the promoter any third party the promoter may identify.

So there's this alternative available to the promoter he may identify a non-resident buyer, in which case the transfer happens between two non-residents, and the FEMA question doesn't arise at all in that scenario. If there's a legal way to perform, there has to be damages for non-performance.

Q: Worried the promoter will move the shares mid-fight? SIAC's new PPO, explained

Shwetha: A PPO (Protective Preliminary Order) in colloquial terms say an ex parte emergency order. But "ex parte" doesn't mean the whole proceeding runs ex parte. Ordinarily, the purpose of a PPO is to protect the right you're seeking relief for in the emergency arbitration application in the first place.

So, if you suspect for example, that the shares which are the subject matter of the put option or exit are going to get rid of or transferred by the promoter and you have evidence that this is about to happen immediately, then the exact relief you're trying to achieve from the emergency arbitration would become futile.

So you try to protect it through a Protective Preliminary Order. You file an application for the appointment of an Emergency Arbitrator (EA) along with a request for a PPO, and that typically gets you the protective order within 24 hours. But this comes with a timeline of three days at best, within which you have to notify the other side; the other side then gets an opportunity to be heard, and the EA passes an order accordingly.

So this is an extra tool in the toolkit to safeguard your rights in urgent situations where you suspect the other side may engage in some sort of foul play in those cases.

Q: You won damages on your put. Who takes the shares back?

Rohit: The offer to surrender is made so you avoid double recovery if you get paid and also keep the shares, that raises a double-recovery question.

You want to avoid the notion that you're being paid twice, so you can't keep both the money and the shares. And once you've been paid, you probably wouldn't want to keep the shares anyway or you want to exit; you don't want to remain involved with the company. So it doesn't really serve the purpose to keep them.

This is what has been done in every single case: in Docomo, for instance, payment was ordered against the tender of shares. In most of the other cases there was a requirement to surrender the shares. The real question is: who do you give them back to? This is where there's an interesting gap, because the cases don't seem to provide a clear answer.

Q: What was the position taken by RBI in the Tata Docomo case?

Kamran: Interestingly, it filed an RTI application with the RBI, and took out all of the RBI's internal notings on the case, and produced them before the court.

Even in the internal notings of the RBI, the officers were writing to each other saying that this is not an open-ended assured return it only protects the downside 30% of the invested amount, and therefore the RBI should be facilitating the honouring of such agreements. These parties relied on the RBI's own internal notings in the Docomo case to argue that this, again, was not an open-ended, assured-return arrangement, and that the courts also held that the question of remittance was a separate matter for the RBI.

First, they argue that the RBI has no standing to appear before the enforcement court and resist enforcement. Second, they say that this is not really an assured return, and therefore not in violation of FEMA, and therefore the award is enforceable.

Q: Has the RBI actually cleared money leaving India under a put award?

Kamran: This was appealed to the Supreme Court under a special leave petition. And the Supreme Court then directly impleaded the RBI they in fact called the RBI and asked it, point-blank, to appear before the court and explain its position on the whole situation.

The RBI makes two points in its affidavit. The RBI takes these two positions: First, the RBI says that the agreement providing for a put option with an assured return was, of course, not permissible under FEMA. However, because this award is a damages award in that sense, a money decree it has changed its color. The transaction now becomes a current account transaction, for which no permission is needed. That was the RBIs position in GPE.

Q: FEMA objections or pro-enforcement courts: which public policy wins?

Kamran: A few weeks back, I was speaking with a judge who has been on the arbitration roster for a long time, and the discussion was centering on how it has now almost become the public policy of Indian law to enforce arbitral awards.

So how do you balance that public policy? You keep hearing counter-arguments that it violates FEMA, that it violates this or that and that that's not public policy. But enforcing arbitral awards has also now become a matter of public policy in Indian law.

Q: Put and buybacks: why does one end up in disputes far more often?

Rohit: Enforcing a buyback a lot more statutory controls that you need to look into. With a buyback, it's corporate-law driven.

There are issues under various corporate laws here we're discussing India, so Indian corporate law will have various requirements that need to be strictly followed, and if they're not, that leads to various issues. The key difference for our audience and I know we have a diverse audience is that a put is a contract, and it binds a person: there's a promoter and/or a third party.

And then you have the investor who's selling shares to that promoter or third party that's how a put really operates, put simply. Whereas a buyback is quite different: it's the company buying back its own shares, and in India there are statutory ceiling limits within which a buyback can operate. That's where you see the real difference between the two mechanisms.

To be quite honest, I don't see buybacks going to disputes as much as puts do, for the reasons we've discussed here. I think the assured-return issue does arise, and the FEMA issue arises even in the context of a buyback you'd be better placed to discuss that those issues do arise. But in my experience, from the vantage point I mentioned, I see more put disputes than buyback disputes.

Conclusion

Ashish: We've come to the end of the first of our three-part Masterclass series.

I'd like to thank everyone we've had tremendous participation, and thank you to those who stayed with us right to the end. We'll soon be releasing details of the next session in this series, and we hope you'll join us there as well.

Thank you. Thank you all.