

In a move that protects the interests of foreign investors, the Supreme Court of India has delivered a positive judgment in the case of IDBI Trusteeship Services Ltd v. Hubtown Ltd that involved downstream investments into the real estate sector in India. Given below is an outline of the material facts along with an analysis of the judgment and the impact it is expected to have.

Key Highlights

- The Supreme Court has validated a structured equity transaction that was secured on the basis of debt obligations and guarantees of Indian obligors.
- The judgment set aside the decision of the Bombay High Court that held the structure to be a “colourable transaction” set-up with the intent of circumventing Indian foreign exchange control regulations.
- The decision also clarifies that foreign investment in compulsorily convertible debentures of a real estate company in India does not contravene Indian foreign exchange control regulations.

Background

- Nederlandse Financierings-Maatschappij Voor Ontwikkelingsland N.V. (FMO), an entity incorporated under the laws of the Netherlands carried out the following investments in the Indian company Vinca Developers Private Limited (HoldCo), a company involved in the construction and development sector:
 - Investment in equity securities comprising 10% of the HoldCo’s equity capital – remaining equity capital was held by Hubtown Limited (Hubtown).
 - Investment in convertible debentures, which when converted, along with the equity investment, aggregate to 99% of the HoldCo’s outstanding share capital.
- The investment by FMO was contractually determined to be used to purchase optionally convertible debentures (OCDs) issued by Amazia Developers Private Limited and Rubix Trading Private Limited, wholly owned subsidiaries of HoldCo that are also engaged in real estate development (Subsidiaries).
- IDBI Trusteeship Services Limited was the debenture trustee of these OCDs and the redemption of the OCDs was guaranteed by Hubtown in favour of the HoldCo.
- FMO’s nominee on the board of the HoldCo was solely entitled to take decisions with respect to the OCDs and debenture trustee.
- The Subsidiaries failed to make payments on the OCDs and the guarantee was invoked. Hubtown then failed to fulfil its obligations under the guarantee, compelling the debenture trustee to file a petition for the winding-up of Hubtown along with a suit for recovery of dues.

The Decision

- Hubtown raised the following issues in an attempt to avoid its guarantee obligations under the terms of the OCDs:
 - Downstream investments by an Indian company with foreign investment into other Indian companies engaged in the real estate sector contravene Indian foreign exchange control regulations.
 - Foreign equity investments into India are allowed on terms that the investor will not receive any assured return and the investment by FMO was structured to circumvent this requirement.
- The Supreme Court of India was of the view that the guarantee was between two Indian entities, i.e. debenture trustee and HoldCo, and invoking the guarantee was valid.
- It was also of the view that FMO’s investment in equity and compulsorily convertible debentures (also considered equity under Indian foreign exchange laws) in a company engaged in the real estate sector was in compliance with India’s foreign investment guidelines.
- The decision also held that even though FMO could have become the 99% shareholder of HoldCo, and HoldCo would have been entitled to receive redemptions from the OCDs issued by the Subsidiaries, such a structure did not contravene Indian foreign exchange control regulations.
- In conclusion, the Supreme Court ordered Hubtown to deposit the principal sum due, or provide it as a security deposit to the Bombay High Court, in case it decided to further contest its obligations.

The Impact

- A lot of investors in the real estate sector that were embroiled in disputes with developers will now be able to monetize their investments.
- The decision has brought about legal certainty to deal structures with downstream investments and to the use of synthetic instruments like compulsorily convertible debentures.
- The Supreme Court’s order to Hubtown to deposit the sum due is also likely to deter Indian obligors like Hubtown from initiating frivolous litigation and using the legal system to circumvent their payment obligations to foreign investors.

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