An analysis of the Supreme Court’s decision in IDBI Trusteeship Services Limited v. Hubtown Ltd.

By Shashank Prabhakar

The Supreme Court’s decision in *IDBI Trusteeship Services Limited v. Hubtown Ltd.*, has provided much needed relief for the foreign investor community. Whilst the decision is a landmark for laying down the law on procedure to be followed in summary suits, the court’s observation on the issues involving FEMA regulations and the FDI policy is no less important.

The facts are that FMO, a foreign investor, subscribed to 10% equity and 3 Compulsory Convertible Debenture (“CCDs”) in Vinca (an Indian company) for a sum of Rs. 418 crores. The rest of Vinca’s equity was owned by Hubtown, an Indian company, and its individual promoters (also Indian residents), who held the remaining 49% and 41%, respectively. Upon conversion of the 3 CCDs, FMO would have been entitled to 99% equity in Vinca, which would have reduced Hubtown and the individual promoters’ stake to just 1%. Although Vinca was engaged in a township project, the funds received from FMO were meant to be invested in 3 of Vinca’s subsidiaries which were engaged in slum rehabilitation projects. Pursuant to this arrangement, Vinca invested in optionally fully convertible debentures (“OPCDs”) issued by the subsidiaries, from the funds received from FMO. The OPCDs issued by the three subsidiaries carried a coupon rate of 14.75% pa, payable to Vinca.

To secure the OPCDs and to guarantee punctual repayment, Hubtown had issued an unconditional and irrevocable corporate guarantee in favour of IDBI, the debenture trustee to the transaction. When the subsidiaries defaulted in payment of the coupon rate to Vinca, IDBI tried redeeming the OPCDs, including the principal amount and unpaid interest thereon. When the subsidiaries failed to pay the amounts due, IDBI enforced the corporate guarantee issued by Hubtown. When Hubtown failed to pay, IDBI filed a summary suit before the Bombay High Court to enforce the corporate guarantee, on behalf of Vinca.

In defense of IDBI’s claim to the amounts guaranteed under the corporate guarantee, Hubtown argued that the transaction was a colorable and artificially structured transaction, designed to enable FMO to secure a fixed rate of return on its FDI investments, contrary to the FEMA regulations. It also argued that FMO could not have directly subscribed to OPCDs and that Vinca was interposed merely as a
nominal recipient of FDI to circumvent the FEMA regulations. The single judge of the Bombay High Court agreed with Hubtown and granted leave for Hubtown to defend its suit on the following grounds:

- FEMA regulations permit investments in townships, construction of houses, etc. permit investments in the form of equity shares or CCDs and prohibit non-equity investments like OPCDs carrying an assured return.
- There was no commercial purpose for interposing Vinca as a holding company since it was merely a nominal recipient of the FDI from FMO. FMO could not have directly subscribed to OPCDs as that would have been contrary to the FEMA regulations. Vinca was interposed only for the purpose of enabling FMO to reap assured returns in its investments. FMO is as much a party to the colorable device / structure as Hubtown.
- The transaction documents stipulated that Vinca would exclusively use the funds received from FMO only to subscribe to OPCDs issued by its subsidiaries and that since Vinca could not use the funds for its own projects, the investment by FMO could not have been compliant with Press Note 2 of 2005.
- The corporate guarantee provided by Hubtown to Vinca was part of the illegal structure and its purpose was to ensure an assured return on its investment. Since the guarantee was issued in support of an illegal structure or scheme, it is prima facie illegal and unenforceable.
- Even though the suit before the HC was brought by the debenture trustee, it was filed at the behest of FMO nominated directors on the board of Vinca, who were granted exclusive powers to issue instructions to the debenture trustee and deal with the OPCDs. The courts will not assist a party in achieving what the law prohibits / declares illegal.

The approach taken by the SC was remarkably different from that of the High Court. The SC while setting aside the order noted that investment by FMO into Vinca by way of equity shares and CCDs which was in compliance with the FEMA regulations. The court also noted that payment by Hubtown, under the corporate guarantee to Vinca would not violate FEMA regulations. Further, if and when FMO became a 99% equity shareholder of Vinca, post conversion of the CCDs, FMO could use the funds received into Vinca to structure its other Indian investments or if it wished to repatriate, it would have to seek RBI’s permission and if so granted by the RBI, there would be no violation of FEMA regulations. These factors were sufficient to decide that Hubtown’s defense was merely “plausible but improbable”.
It is important for us to pay close attention to what was not said by the SC than what was said, in this case, even though they are merely prima facie observations. Unlike the Bombay High Court, the SC did not analyze the provisions of the share subscription agreement or the debenture trustee deed or try to second guess the purpose of the transaction, nor did it examine as to whether or not the transaction was a colorable or an artificially structured transaction, designed to do something indirectly what they could not do directly. The court also did not try to lift the corporate veil or adopt a substance over form approach to recast the transaction, like the High Court. Since the corporate guarantee was between two Indian companies, the court found that it had no FEMA implications. Once it was satisfied that the initial investment into Vinca was in accordance with the FEMA regulations and repatriation, if at all, would also necessarily have to comply with the FEMA regulations, the court did not even concern itself with analyzing how or why the downstream investments by Vinca were structured in the manner that it was.

The High Court had refused to grant relief to the petitioner (IDBI), even though there was no finding that the corporate guarantee had been invoked incorrectly. In support of its judgment, the High Court had cited a previous Supreme Court decision of Immami Appi Rao v. G. Ramalingamurthi (AIR 1962 SC 370), where it had held that when there are two persons who are party to an illegality, the court would be justified, in the larger public interest, in not lending the court’s aid to a person who comes to court to enforce such illegality. Since the corporate guarantee was held to be part of a larger illegal transaction, the court refused to grant relief to IDBI. The SC disagreed with this analysis and held that the proposition laid down in Immami would only apply if the illegal purpose had actually been carried out, and not otherwise. This clarification is important for it precludes judges from second guessing the parties’ motives behind claiming reliefs. The High Court seemed all too eager to disregard the form of the transaction in order to arrive at what it felt was the substance of the transaction and pierce the corporate veil even in the absence of any evidence of anything illegal having been committed by FMO. Given that these observations are merely prima facie in nature, one hopes that this analysis is followed by other lower courts as well.

*Shashank Prabhakar is a Senior Associate at Finsec Law Advisors.*