

# Regulatory Hotline

June 09, 2015

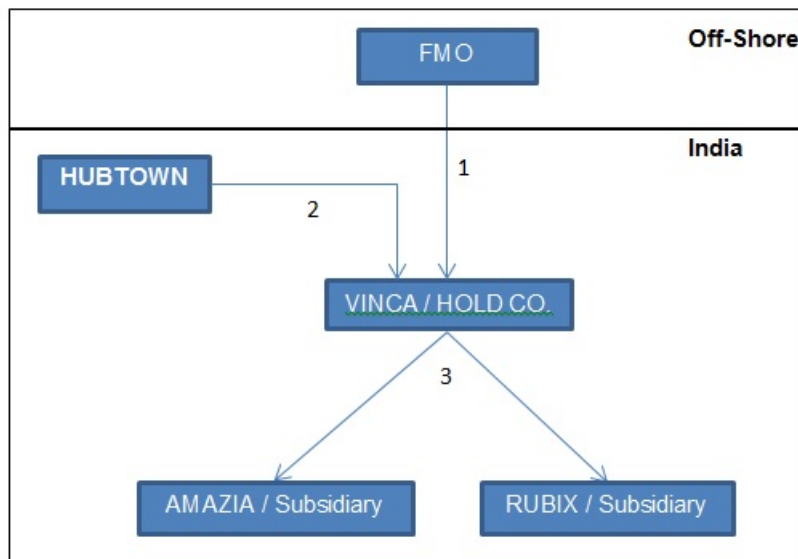
## FOREIGN INVESTMENT STRUCTURE SEEN AS A 'COLORABLE DEVICE' AND HELD ILLEGAL

- Bombay High Court evaluates a downstream FDI structure to rule that investment in the holding company was a 'sham' structured to invest downstream by way of redeemable instruments.
- Court would not provide assistance in enforcement of transactions which are not compliant with the FDI Policy and FEMA Regulations.
- Courts follow the regulatory approach and scrutinize the various steps in a transaction to hold that such transaction as intended to provide assured return which is not permitted under the FDI Policy and FEMA Regulations.

### INTRODUCTION

The recent ruling of the Bombay High Court sets out the approach of the courts to scrutinize transactions to ascertain if the objective of the transaction or the series of connected transactions are compliant with the law. The Court in *IDBI Trusteeship Services Limited* ("IDBI" or "**Petitioner**") v. *Hubtown Limited* ("**Hubtown**" or "**Respondent**") declared an investment of INR 418 crores in the holding company as colorable device used to circumvent the Foreign Direct Investment Policy ("**FDI Policy**") and the regulations framed under the Foreign Exchange Management Act, 1999 ("**FEMA Regulations**") to provide an assured return.

### BACKGROUND AND FACTUAL MATRIX



#### 1. FMO invested into Hold Co. through subscription of CCDs

- Nederlandse Financierings- Maatschappij Voor Ontwikkelingslandeo N.V. ("**FMO**") is a corporation formed under the laws of Netherlands. FMO held 10 percent of the shareholding in Vinca Developers Private Limited ("**Vinca**" or "**Hold Co.**") and 3 Compulsorily Convertible Debentures ("**CCDs**") issued by Vinca.
- The CCDs were convertible within a period of 60 months and upon conversion FMO would hold 99% of Vinca's equity.
- Vinca was involved in the construction development sector and had an FDI eligible township project.

#### 2. Hubtown/Promoters hold the balance shares of the Hold Co.

- Hubtown and individual promoters held the balance 90 percent shareholding in Vinca which was to be diluted upon conversion of the CCDs.

#### 3. Hold Co. invested in the subsidiaries through subscription of OGDs

- Vinca had contractually agreed that the investment by FMO would be used to purchase Optionally Convertible Debentures ("**OCDs**") issued by Amazia Developers Private Limited ("**Amazia**") and Rubix Trading Private Limited ("**Rubix**"), who are wholly owned subsidiaries of Vinca. Accordingly, the amounts invested by FMO were infused into Amazia and Rubix (together referred to as "**Subsidiaries**").
- The Petitioner is the Debenture Trustee in regard to the OCDs.
- The Articles of Association ("**AoA**") of Vinca/Hold Co. were amended such that FMO Nominee Directors on Vinca's

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Board of Directors would alone be entitled to take all decisions regarding the OCDs and the Debenture Trustee.

- Hubtown provided a guarantee in favour of Vinca for the performance of the obligations by the Subsidiaries with respect to the OCDs.

Upon failure by the Subsidiaries to make the payments on the OCDs, the guarantee provided by Hubtown was invoked. Subsequently, upon failure of Hubtown to make the payments pursuant to the invocation of the guarantee, the Debenture Trustee filed a petition for winding up Hubtown and also a summary suit for recovery of the dues.

In both the proceedings, it was contended by Hubtown that the structure was itself in violation of the FDI Policy and hence the guarantee being part of the transaction is also unenforceable. It was argued that by interposing the Hold Co. in the middle and arranging the contractual and shareholder rights in such manner, FMO was looking to obtain an assured return on its investment which was not permitted under the FDI Regulations/FDI Policy.

## JUDICIAL REASONING

The Bombay High Court applied the principle laid down in *Vodafone International Holdings BV v. Union of India*<sup>1</sup> wherein it was held that the Court must look at the entire transaction as a whole and not adopt a dissecting approach while ascertaining whether a transaction is being used as a colorable device. The court also relied on precedents to hold that Court's assistance could not be taken to enforce prohibited/illegal transactions and that the exchange control regulations formed part of the public policy of India.

In this backdrop, the Court examined the adopted investment structure for the transaction and noted the following points with respect to the structuring of the investment:

### 1. FDI received by the Hold Co was mandated to be only invested downstream by way of subscription of OCDs.

The Court rejected the contention of the Petitioner that the investment by FMO in the Hold Co. was in accordance with Press Note 2 of 2005 as the Hold Co. has a township project which is an FDI eligible project.

The court took note of the fact that the agreements required the Hold Co. to immediately pass the FDI received from FMO to the Subsidiaries against subscription of OCDs. Hold Co. was not allowed to retain the FDI amount or to utilize the same in any of its projects. Press Note 2 of 2005 permits FDI investment in the real estate sector only if it is for township/construction project. Accordingly, the court held that the investment in the Hold Co. cannot be said to be in accordance with Press Note 2 of 2005 and is not FDI compliant.

It was contended by the Petitioner that the Hold Co. being a separate legal entity, there was no bar on it to invest the amount received from FMO in OCDs of the Subsidiaries and the investment by the Hold Co. could not be treated as an investment by FMO. The Court rejected the contention on the same ground that the agreements established that the Hold Co. did not have an option but to route the funds to the Subsidiaries.

### 2. Investment by the Hold Co. in the Subsidiaries was through subscription of OCDs as opposed to instruments considered as equity under the FDI Regime

The Court rejected the contention of the Petitioner that FMO could have directly invested in the Subsidiaries by CCDs and obtained a fixed rate of return as there is no prohibition against CCDs bearing interest under the FDI Policy.

FDI Policy restricts investment through redeemable (whether in part or full) instruments, and obtaining assured returns. It was noted by the Court that FDI Policy & FEMA Regulations permits equity investment i.e. where equity risk is taken by the foreign investor. CCDs are compulsorily convertible into equity and are treated as an equity instrument under the FDI Regime. However, the instrument used was OCDs which allowed FMO to ensure that the Hold Co. obtains the investment amount along with the interest. Thus, the equity risk was not borne by the investors.

### 3. The cash up streamed would belong to FMO since the CCDs issued by Hold Co. to FMO could convert into 99% of the capital of the Hold Co.

It was also argued that the investment by FMO was ultimately in form of CCDs in the Hold Co, sale of which would be subject to the pricing guidelines and would not be able to obtain a price higher than that stipulated by the RBI.

However, the Court noted that structure was designed in such a manner to ensure that on receipt by the Hold Co. of the principal amount invested in the Subsidiaries along with the interest, FMO on conversion of its CCDs would become the owner of the Hold Co. and thereby receive/become entitled to the amounts received by the Hold Co. The Court observed that FMO could then sell the shares of Hold Co. at fair value which would necessarily include the value/benefit of the assured return through the OCDs.

The Court also took note of how Articles of Association of the Hold Co. had been amended such as to ensure that the decisions pertaining to matters relating to the OCDs and the enforcement thereof by the Hold Co. are made by the nominee directors of FMO on board of the Hold Co.

Accordingly, the Court held that:

*"I am prima facie of the view that the structure/device of routing FMO's FDI amount of Rs. 418 crores to Amazia and Rubix through the newly interposed Vinca (as the nominal recipient of the FDI) was a colourable device structured only to enable FMO to secure repayment (through Vinca) of its FDI amount and interest thereon at 14.75%, contrary to the statutory FEMA Regulations and the FDI Policy embodied therein, which only permit FDI investment in townships/real estate development sector to be made in the form of equity (including Compulsorily Convertible Debentures) and preclude any assured return. I am also prima facie of the view that the Company's Guarantee (which is the basis of the Company Petition) though ostensibly in favour of Vinca, an Indian Company, was part of the aforesaid illegal structure/scheme and was given to ensure that FMO received back its FDI amount with interest as aforesaid through Vinca. The Guarantee was therefore part of the aforesaid illegal structures/scheme and therefore prima facie illegal and unenforceable."*

However, it is to be noted that observations made by the court in context of the facts and finding that the structure is a colorable device are prima facie in nature and not based on detailed adjudication considering the nature of the legal proceedings which were initiated by the Petitioner.

1. The judgments<sup>2</sup> resonate the regulatory outlook towards foreign transaction and sets out to scrutinize the substance of the transaction rather than the form of it.
2. The Supreme Court in *Vodafone International Holdings BV v. Union of India* ("**Vodafone**") has held that it is the task of the Court to ascertain the legal nature of the transaction and while doing so it has to look at the entire transaction as a whole and not to adopt a dissecting approach. While doing so, if the Court came to a conclusion that it was a colorable device, it had to be treated as *non-est* in the eyes of law.
3. While the '**look at**' test was adopted by the court, the judgments reflects that under such approach the courts are willing to scrutinize the transaction and its various elements to ascertain if the structure is in spirit compliant with the FDI Policy & FEMA Regulations. This willingness to re-characterize the transaction despite the individual steps in isolation seemingly being in compliance with the regulations on the basis of the defense raised by the non-compliant party highlights the need for high caution to be exercised while adopting certain investment structures.
4. Further, Press Note 2 of 2005 or the FDI Policy did not impose any end use requirements for the FDI received by a Company. However, the findings of the Court with regard to the investment not being in compliance with Press Note 2 of 2005 seems to indicate that FDI received is required to be utilized in the FDI eligible projects of the Company and connected requirements and cannot be used for other purposes.
5. The Court has rejected the contention of the Petitioner that even after conversion of the CCDs and FMO becoming 99 percent shareholder of Vinca, FMO will have to follow Reserve Bank of India's ("**RBI**") pricing guidelines and hence the transaction should not be treated as a colourable device. However, the Court has not expressly stated how the equity risk is not on FMO as the Hold Co. was not a shell entity. Thus, while Vinca would obtain the returns on the amounts invested in Amazia and Rubix and derive benefits thereof, price received by FMO upon exit from Vinca would also be affected by loss if any incurred by Vinca in its existing business. It appears that the extent of Hold Co.'s business and its potential impact on valuation at which FMO may exit from Hold Co. thereby being considered as an investment wherein equity risk is taken by the foreign investor may be a question which may be determined post a detailed adjudication.
6. Lastly, the Court has relied upon the observations of the Supreme Court in *Renusagar Power Sugar Company Limited v General Electric Company*<sup>3</sup>, to hold that the foreign exchange related enactments are enacted to safeguard the economic interest of India and are therefore part of the public policy of India. Hence, arbitral awards challenged or objected to under Section 34 and Section 48 of the Arbitration and Conciliation Act, 1996 for similar structures may also be subject to such court scrutiny to ascertain if the transaction was in compliance with the extant exchange control regulations. Therefore such objections may also lead to delay in final enforcement of the arbitral awards. Thus, serious caution ought to be exercised by Investors while considering various modes whereby they may invest.

– **Satish Padhi, Ashish Kabra & Ruchir Sinha**

You can direct your queries or comments to the authors

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<sup>1</sup> (2012) 70 Com Cases 369

<sup>2</sup> Separate judgments were passed in the two proceedings i.e. the petition for winding up and the summary suit.

<sup>3</sup> AIR 1994 SC 100%

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