



## Regulatory Alert Tracking change

### FDI structure comes under the regulatory scanner

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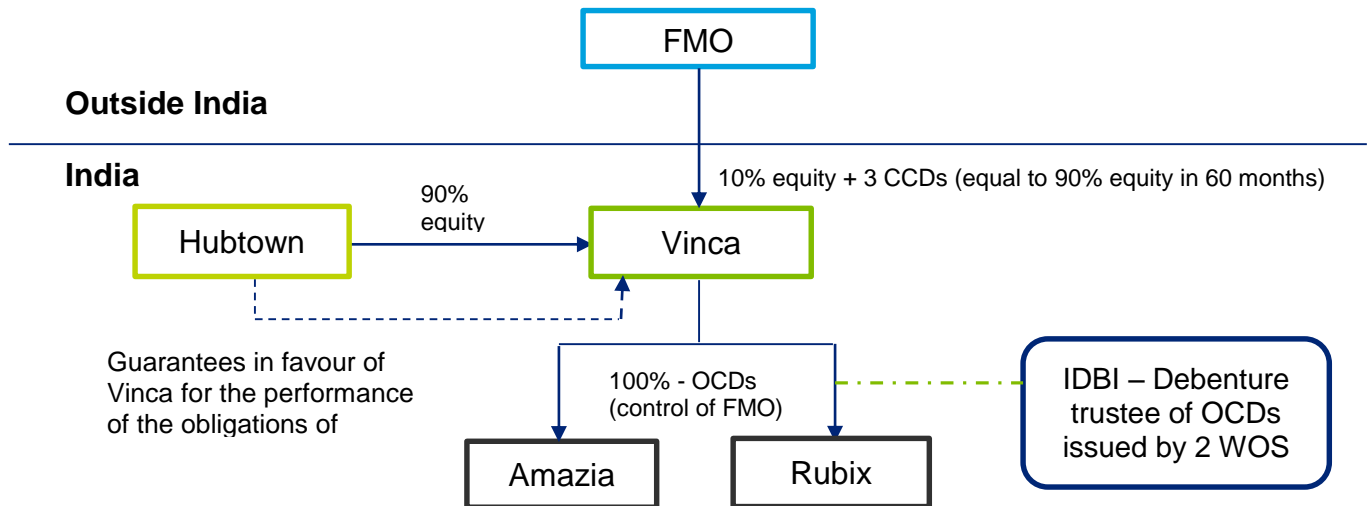
# Synopsis

- Bombay High Court evaluates a downstream Foreign Direct Investment (FDI) structure and holds on facts that prima facie:
  - A holding company structure was interposed only for the purpose of FDI into downstream wholly owned subsidiaries through the holding company as a nominal recipient.
  - The transaction of routing FDI through the newly interposed company was a colourable device and structured to enable the foreign investor to secure repayment of FDI and assured return which is not permitted under the FDI Policy and FEMA Regulations and prohibited by law.

# Facts

- Nederlandse Financierings- Maatschappij Voor Ontwikkelingslandeo N.V. (FMO), a corporation formed under the laws of Netherlands held 10% 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.
- The Hubtown Ltd. (Defendant) and individual promoters held the balance 90% shareholding in Vinca which was to be diluted upon conversion of the CCDs.
- 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), which are wholly owned subsidiaries (WOS) of Vinca. Accordingly, the amounts invested by FMO were infused into Amazia and Rubix (together referred to as Subsidiaries).

- Diagrammatic representation:



- The IDBI Trusteeship services Ltd. (Plaintiff) was Debenture Trustee in regard to OCDs.
- The Articles of Association (AoA) of Vinca were amended such that FMO Nominee Directors on Vinca's Board of Directors would alone be entitled to take all decisions regarding the OCDs and the Debenture Trustee.
- The Defendant 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 its failure 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 which was sought to be defended by Hubtown.

## Key issue raised by Hubtown

Where an Indian Company receives FDI and the proceeds are invested in OCDs of companies operating in the construction development sector, such downstream investment by the FDI recipient company violates the FDI Policy and FEMA regulations.

# Hubtown submissions

- FDI Policy and the statutory FEMA Regulations (which incorporate the FDI Policy as a Schedule thereto), permit FDI in townships, construction of houses, only by way of equity investments (which is defined to also include debentures which are compulsorily required to be converted into equity). The FDI Policy and the FEMA Regulations prohibit any other form of investment (non-equity) in the said sector with an assured return / rate of return.
- An Indian Company, which has received foreign direct investment, can employ its funds downstream viz. moving funds into its subsidiaries only by making investments in the form of Equity Capital or compulsorily and mandatorily convertible preference shares or debentures. Vinca therefore could only have subscribed for convertible debentures of Amazia and Rubix and consequently, Vinca's investment in Amazia and Rubix in the form of OCDs does not satisfy the definition of capital and is in violation of the FDI policy for downstream investments made by an Indian Company with FDI.
- That investment by an Indian Company in OCDs issued by its subsidiaries would amount to an external commercial borrowing (ECB). Therefore, Vinca's investment in OCDs issued by Amazia and Rubix in real estate sector is forbidden by the FEMA Regulations (ECB guidelines).

## Ruling of the High Court

- The Court examined the facts and reached a prima facie conclusion that Vinca was only a nominal recipient of investment from the foreign investor and the FDI amount was routed by Vinca to Amazia & Rubix against issue by them of OCDs bearing a return of 14.5% per annum.
- The downstream investment by Vinca in its subsidiaries was contractually predetermined. Since the foreign investor could convert its CCDs into 99% shareholding in Vinca, in effect, the foreign investor would receive an assured return on its investment, which was not permitted under the FDI regulations.
- The Court also noted that the FDI regulations only permit FDI by way of equity or compulsorily convertible instruments (CCDs) in Indian companies. Accordingly, while the foreign investor could have directly invested in CCDs bearing interest of Amazia and Rubix,

the amounts invested would be compulsorily required to be converted into equity shares of Amazia and Rubix and the foreign investor could not have required Amazia or Rubix to repay the amounts invested.

- The Court, relying on the 2012 decision of the Supreme Court of India in Vodafone International Holdings BV v. Union of India, held that whilst ascertaining the legal nature of the transaction it is the task of the court to look at the entire transaction as a whole and not to adopt a dissecting approach. Further, a device which was colourable in nature has to be ignored. In the present case, on facts, prima facie, the structure was devised to circumvent the restrictions imposed by the FDI regulations.
- The court allowed the defendant (Hubtown) to defend the suit. The hearing of the suit is to be expedited and the court will endeavour to dispose of the suit within a period of 1 year.

## Conclusion

- The High Court decision may require a careful evaluation of similar existing structures for enforceability by the parties and may also be examined by the regulators.
- While the 'look at' test was adopted by the court, the judgment 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.
- 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.

**Source:** Ordinary Original Civil Jurisdiction summons for judgement NO. 39 of 2013 in summary Suit No. 520 of 2013 – IDBI Trusteeship Services Ltd vs. Hubtown Ltd.

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# Contacts

## Ahmedabad

Heritage, 3rd Floor,  
Near Gujarat Vidyapith,  
Off Ashram Road,  
Ahmedabad – 380 014.  
Tel: + 91 (079) 2758 2542  
Fax: + 91 (079) 2758 2551

## Coimbatore

Shanmugha Manram  
41, Race Course,  
Coimbatore  
Tamil Nadu - 641018  
Tel: + 91 (0422) 439 2801  
Fax: +91 (0422) 222 3615

## Kolkata

Bengal Intelligent Park Building Alpha,  
1st floor, Block EP and GP Sector V,  
Salt Lake Electronics Complex,  
Kolkata - 700 091.  
Tel : + 91 (033) 6612 1000  
Fax : + 91 (033) 6612 1001

## Bangalore

Deloitte Centre, Anchorage II,  
100/2, Richmond Road,  
Bangalore 560 025.  
Tel: +91 (080) 6627 6000  
Fax: +91 (080) 6627 6010

## Delhi/Gurgaon

Building 10,  
Tower B, 7th Floor,  
DLF Cyber City,  
Gurgaon 122 002  
Tel : +91 (0124) 679 2000  
Fax : + 91 (0124) 679 2012

## Mumbai

Indiabulls Finance Centre,  
Tower 3, 28th Floor,  
Elphinstone Mill Compound,  
Senapati Bapat Marg, Elphinstone (W),  
Mumbai – 400013  
Tel: + 91 (022) 6185 4000  
Fax: + 91 (022) 6185 4101

## Chennai

No.52, Venkatanarayana Road,  
7th Floor, ASV N Ramana Tower,  
T-Nagar,  
Chennai 600 017.  
Tel: +91 (044) 6688 5000  
Fax: +91 (044) 6688 5050

## Hyderabad

1-8-384 and 385, 3rd Floor,  
Gowra Grand S.P.Road,  
Begumpet,  
Secunderabad – 500 003.  
Tel: +91 (040) 6603 2600  
Fax: +91 (040) 6603 2714

## Pune

106, B-Wing, 7<sup>th</sup> Floor,  
ICC Trade Tower,  
Senapati Bapat Road,  
Pune – 411 016.  
Tel: + 91 (020) 6624 4600  
Fax: +91 (020) 6624 4605

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