The Growing Significance of Put Options in Shareholder's Agreement

ABSTRACT

Put options have emerged as a cornerstone of Shareholder Agreements (SHAs), offering a strategic exit mechanism that ensures fairness, transparency, and risk mitigation. This article delves into the strategic value of put options, particularly for private companies, where market liquidity constraints necessitate robust exit mechanisms, evolution of put options in India, tracing their journey through regulatory challenges under the Securities Contracts (Regulation) Act, 1956, and subsequent clarifications provided by the 2013 SEBI Notification. It also explores key judicial precedents that have solidified their enforceability, highlighting landmark cases such as *Percept Finserve Pvt. Ltd. v. Edelweiss Financial Services Ltd.* and *Banyan Tree Growth Capital LLC v. Axiom Cordages Limited*. This article covers valuable insights into the role of put options as transformative tools in modern corporate governance, advocating for their thoughtful inclusion in SHAs to foster sustainable and equitable business practices.

STRATEGIC EXIT MECHANISM

An exit in Shareholders' Agreements refers to the mechanisms enabling shareholders to divest their stakes in a company, ensuring smooth transitions, resolving potential deadlocks, and safeguarding interests. Among these, put options are a standout strategy, granting shareholders the contractual right, but not the obligation to sell their shares to a designated party, typically a co-shareholder, the company, or a third party, at a predetermined price or valuation formula. Unlike call options, which provide the right to purchase, put options empower shareholders to exit under agreed terms, mitigating risks associated with unfavourable market conditions or declining company value. This mechanism is particularly advantageous in private companies, where shares are not freely traded, offering clarity and fairness to existing shareholders.

The put option exit strategy ensures that shareholders can divest their stakes at a fair and pre-agreed price, shielding them from potential losses if the company's valuation drops. It also creates a binding obligation on the buyer, ensuring that the designated counterparty; whether another shareholder, an investor, or a third party purchases the shares under the agreed terms. This predefined exit mechanism fosters transparency, minimizes disputes, and serves as a critical risk-mitigation tool, making it an essential feature of Shareholders' Agreements.

The enforceability of put options in private companies has historically faced significant challenges. Regulatory barriers, particularly under the Securities Contracts (Regulation) Act, 1956 (**"SCRA"**), often rendered contracts involving options speculative and void. Additionally, disputes frequently arise over triggering conditions, enforcement procedures, and valuation methodologies, leading to uncertainty for shareholders. Judicial interpretations further compounded the issue, as inconsistent rulings created ambiguity about the legality and enforceability of such clauses. However, a pivotal development came with the SEBI Notification dated October 3, 2013, issued under Sections 16 and 28 of the SCRA[1]. This notification provided much-needed clarity by recognizing shareholders' agreements containing put options as valid, provided they adhere to prescribed conditions. It not only resolved many ambiguities but also reinforced the legitimacy of such contractual arrangements. By offering statutory recognition, the notification bolstered the confidence of investors, ensuring that put options could serve as a reliable and enforceable exit strategy. Today, while challenges like valuation disputes and procedural delays persist, the regulatory framework has evolved to provide a clearer path for enforcing these rights, particularly in private company settings.

REGULATORY EVOLUTION

The enforceability of put options in India has evolved significantly over the years, marked by key regulatory milestones:

1. 1969 Notification under the SCRA: The Central Government issued Notification S.O. 2561 on June 27, 1969[2], declaring that all contracts for the sale or purchase of securities, other than spot delivery contracts or contracts for cash or hand delivery or special delivery, were illegal and void. This move aimed to curb speculative trading and maintain market integrity.

2. 1995 Amendment to the SCRA: Section 20 of the SCRA, which imposed certain restrictions on securities contracts, was omitted in 1995 to permit put option clauses. However, the 1969 Notification remained in force, continuing to create regulatory uncertainty surrounding such options.

3. 1999 SCRA Amendment and Introduction of Section 18A: The SCRA was amended in 1999 to introduce Section 18A, which provided that contracts in derivatives shall be legal and valid if they are:

   (a) traded on a recognized stock exchange;

   (b) settled on the clearing house of the recognized stock exchange, in accordance with the rules and bye-laws of such stock exchange; or

   (c) between such parties and on such terms as the Central Government may, by notification in the Official Gazette, specify.

4. March 1, 2000 SEBI Notification: To reinforce the 1969 directive, SEBI issued Notification S.O. 184(E) on March 1, 2000[3]. This notification prohibited entering into contracts for the sale or purchase of securities, except for spot delivery contracts,

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[1] Securities and Exchange Board of India, **Notification under Section 16 and 28 of Securities Contracts (Regulation) Act, 1956**, available at: https://www.sebi.gov.in/sebi_data/attachdocs/1448966221407.pdf.

[2] Sinha, A., "Enforceability of Put Options under Indian Law," **Manupatra Articles**, available at: https://docs.manupatra.in/newsline/articles/Upload/389C4481-FFE8-4F4A-B0C1-E86591BB48D5.pdf.

[3] **Securities and Exchange Board of India (SEBI), Notification**, issued under Sections 29A and 16(1) of the Securities Contracts (Regulation) Act, March 2000, available at: https://www.sebi.gov.in/legal/acts/mar-2000/notifications-under-sections-29a-and-16-1-of-the-securities-contracts-regulation-act_41585.html.

contracts for cash or hand delivery or special delivery, and contracts in derivatives as permissible under the SCRA or SEBI regulations. The objective was to prevent undesirable speculation in securities across India.

5. 2011 SEBI Informal Guidance: In 2011, SEBI provided informal guidance, opining that option contracts, including put options, were akin to forward contracts or derivatives. As such, they did not fall within the scope of spot delivery contracts and were considered non-compliant with the existing regulatory framework. This interpretation complicated the enforceability of such options in shareholder agreements.

These regulatory developments reflect the evolving stance on the legality and enforceability of put options in India, highlighting the complexities stakeholders have navigated over the years.

JUDICIAL PRECEDENTS

The enforceability of put options has been a subject of extensive judicial scrutiny in India, with landmark rulings providing much-needed clarity. In *Percept Finserve Pvt. Ltd. v. Edelweiss Financial Services Ltd*[4]., the Bombay High Court addressed the legal framework surrounding put options under the Securities Contracts (Regulation) Act, 1956 (SCRA). The Division Bench, comprising Hon'ble K.R. Sriram and Hon'ble S. Patil, held that a put option is not a forward contract, as the contractual obligation arises only upon the occurrence of a specific event or the exercise of the option. The Court further clarified that such contracts qualify as spot delivery contracts when the repurchase of securities occurs promptly upon the option's exercise. The ruling also distinguished put options from derivative contracts under Section 18A of the SCRA, emphasizing that the prohibition applies only to the trading of such options as securities and not to their inclusion in shareholder agreements.

Building on these principles, the Bombay High Court in *Banyan Tree Growth Capital LLC v. Axiom Cordages Limited* [5]reaffirmed the legality of put options as a mechanism for shareholder exit. The case involved a buyback arrangement under a Put Option Deed, which the petitioner exercised in 2015. The Court reiterated that such arrangements are not classified as derivatives under Section 18A of the SCRA. Furthermore, it recognized the enforceability of the Put Option Deed under the SEBI Notification dated October 3, 2013, which provided statutory recognition to shareholder agreements containing put and call options, even if executed prior to the notification. By emphasizing that the option came into effect only upon its exercise, the Court distinguished it from speculative forward contracts.

Together, these rulings underscore the evolving jurisprudence on put options, providing a cohesive framework for their inclusion in shareholder agreements. They affirm that put options are not inherently speculative or prohibited under the SCRA, provided they comply with

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[4] Percept Finserve (P) Ltd. v. Edelweiss Financial Services Ltd., **2023 SCC OnLine Bom 319**, decided by the Division Bench of the Bombay High Court comprising Hon'ble K.R. Sriram and Hon'ble S. Patil, JJ.

[5] **Banyan Tree Growth Capital L.L.C. v. Axiom Cordages Limited**, High Court of Bombay, judgment dated April 30, 2020, available at: https://cdn.ibclaw.online/ADR/HC/2020/Banyan+Tree+Growth+Capital+L.L.C.+Vs.+Axiom+Cordages+Limited+-+High+Court+of+Bombay-30-04-2020.pdf.

statutory regulations. These decisions have enhanced the legal certainty surrounding shareholder exits, making them an essential tool for investors in private companies.

The strategic value of put options in exit scenarios lies in their ability to offer shareholders a well-defined, secure pathway to divestment, particularly in private companies where market liquidity is limited. By allowing shareholders to exit at a predetermined price or valuation, put options serve as a robust risk mitigation tool, shielding them from potential losses during market downturns or declining company valuations. This predetermined pricing mechanism not only ensures transparency but also fosters a sense of fairness among all stakeholders by eliminating ambiguities over valuation disputes. Moreover, the binding nature of put options obligates the counterparty whether another shareholder, the company, or a third party to honour the exit terms, thereby safeguarding the contractual integrity of shareholder agreements. These features collectively make put options an indispensable strategy for investors seeking to balance their risk exposure while ensuring a smooth and predictable exit in line with their financial goals.

CONCLUSION

The evolution of put options as a robust exit strategy in SHAs reflects their growing importance in in the transaction documents. Having analysed the historical regulatory and judicial challenges, it is evident that the 2013 SEBI Notification was pivotal in addressing enforceability concerns, thereby instilling greater confidence among shareholders. Judicial precedents further underscore the critical role of put options in striking a balance between protecting shareholder interests and ensuring contractual certainty.

From my perspective, these developments underscore the transformative potential of put options in fostering fairness and transparency, particularly in private companies. Despite being a riskier derivative, the thoughtful and strategic allocation of put options in a Shareholders' Agreement (SHA) can enable a profitable and efficient exit for investors. Put options serve as a practical mechanism to protect the value of investments, particularly when traditional exit routes such as an initial public offering are not feasible, liquidation or voluntary winding up proceedings are too time consuming, or regulatory constraints make buybacks by the investee company cumbersome.

To maximize the benefits of put options, investors must exercise precision in analysing the company's financial health and growth potential before investing. Accurate valuation at the entry stage is crucial, especially in scenarios where the company's future performance might pose risks. This enables investors to plan and execute a well-structured exit strategy effectively.

When incorporated with foresight and precision, put options transcend their role as mere contractual tools. They become vital instruments for aligning stakeholder expectations, mitigating risks, and fostering sustainable and equitable business practices in today's complex corporate landscape. Their ability to balance investor protection with contractual certainty underscores their transformative potential in modern SHAs, solidifying their position as indispensable elements of robust exit strategies.