CHAPTER V

JUDICIAL RESPONSE TO REGULATION OF FINANCIAL DERIVATIVES

While dealing with judicial response to financial instruments including derivative instruments, we need to focus on how the judiciary has viewed individual instruments rather than how it has viewed institutional regulation. The very reason for this is that litigation has never been instituted against institutional regulation, and much work in this area has been done through advocacy and policy interventions by players, individually as well as through groupings of dealers and players such as I.S.D.A. At the same time, as has been seen in earlier chapters, from quiet early days traders used to indulge in creation of this exotic variety of financial products. When the understanding between the parties to the instruments fell foul the losing party used to appear before courts seeking intervention. Eddy Wymeersch in his working paper entitled "Regulation and Case law relating to Financial Derivatives,"[1] has categorised cases relating to financial derivatives as follows: The cases dealing with (a) Judicial Competence[2] (b) Contractual Illegality and (c) Risk arising out of incomplete disclosure.[3] If we refer to a single jurisdiction, it will be difficult to find litigations in all these categories. In Indian context, the question of judicial competence arose with respect to expertise and the

[1] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1988925, accessed on 21.01.2016 at 01.08 hrs.
[2] In this head, the major issue dealt with in the paper is how far UK courts can exercise jurisdiction over bodies outside its territorial jurisdiction. UK courts generally conclude to UK competence, while in several cases the court of the debtor has found ways to affirm their own jurisdiction.
[3] The article mainly analyses decisions of European Court, Belgium, Germany and Italy.

courts have generally found against competence of Indian Courts in cases where there is an arbitration clause. We need to take a closer look at the judicial response to get a clear picture.

INDIAN COURTS AND FINANCIAL INSTRUMENTS

In India, in most of the cases relating to contracts creating monetary instruments, the challenge to the transaction is under Sections 30 and 23 of Indian Contract Act. In fact the legal development relating to the financial instruments can be divided into five phases[4] as follows:

First Phase: Period upto 1848, when the law relating to such contracts were governed by Common law of England and personal law.

Second Phase: From 1848 to 1917, when the law relating to financial derivatives was governed initially by the Provincial Gaming statutes and then by Section 30 of Indian Contract Act. Judicial attitude was towards accepting the wagers as void contracts. During this phase, the strength of Indian futures industry started weakening.

Third Phase: From 1917 to 1950's, when judicial pronouncements started opening up ways for maintaining the financial market for derivatives contracts.

Fourth Phase: From 1950s till 1996, when FCRA and SCRA put a ban on financial derivatives, pushing the financial derivatives industry in India to the grey market.

[4]The periods are not delineated on the basis of year on which the case was reported, but on the basis of the period on which the contract was entered into. It may also be kept in mind that the periods are not calculated exactly but roughly.

Fifth Phase: In 1996 when SCRA was amended to allow derivatives trading in India, judicial recognition of financial derivatives followed through.

A detailed analysis of the above five phases are undertaken below:

First Phase: Open Phase

During the initial period of development of judicial precedents relating to financial derivatives, the courts considered instruments that are today considered as financial derivatives as acceptable contracts. Hence this period can be generally considered as an open phase, where there was no statutory restriction on these instruments, and the courts were liberal in giving legal validity to these contracts on the basis of the personal law of different communities in India.

In 1848, while dealing with one of the earliest reported cases on wager based on a financial contract which can be termed similar to a modern day options contract namely; *Ramlal Thakursidas* v. *Sujanmal Dhondmal*[5], the Privy Council analysed the law relating to wager in Hindu Law. It was held that there is no provision dealing with wagers in Hindu Law. Therefore the Privy Council applied common law of England and held that the wagers are not illegal[6]. Judicial Committee of the Privy Council expressly ruled that the common law of England was in force in India and under that law an action might be maintained on a wager. The wager dealt with in that case was upon the average price which opium would fetch at the next Government sale at Calcutta. Lord Campbell in rejecting the plea that the wager was illegal observed:

[5] (1848) 4 M.I.A. 339.
[6] *Id* at p. 127.

The Statute, 8 & 9 Viet. c. 109[7], does not extend to India' and although both parties on the record are Hindoos, no peculiar Hindoo law is alleged to exist upon the subject; therefore this case, must be decided by the common law of England.[8]

Within two years, in 1850, the Privy Council was again seized of another dispute relating to a derivatives contract. In *Doolubdass Pettamberdass* v. *Ramloll Thackoorseydass and others*[9], the court had to consider a contract based on the price that the Patna opium would fetch at the next Government sale at Calcutta. The plaintiff had instituted a suit in the Supreme Court of Bombay in January, 1847, to recover the money won on a wager. After the suit was filed, Act for Avoiding Wagers, 1848 was passed by the Indian Legislature. Under this Act all agreements whether made in speaking, writing or otherwise, by way of gaming or wagering, would be null and void and no suit would be allowed in any Court of Law or Equity for recovering any sum of money or valuable thing alleged to be won on any wager. This Section was similar in terms to that of Section 18 of the Gaming Act, 1845 of England. Their Lordships at Privy Council held that the contract was not void and the Act for Avoiding Wagers, 1848 would not invalidate the contracts entered into before the Act came into force.

Subsequently in *Raghoonauth Sahoi Chotayloll* v. *Manickchund and Kaisreechund*[10] also, the Judicial Committee of the Privy Council held that a wagering agreement in India upon the average price opium would fetch at a

[7] English Gaming Act of 1845.
[8] Id. at p. 349.
[9](1850) 5 M.I.A. 109.
[10](1856) 6 M.I.A. 251.

future Government sale, was legal and enforceable before the passing of the Act for Avoiding Wagers, 1848.

An analysis of these decisions show that in the first phase of development of law relating to wagers, i.e., before the enactment of the Act for Avoiding Wagers, 1848, wagering agreements were governed by the common law of England and were not void and therefore enforceable in Courts. They also held that the Hindu Law did not prohibit any such wagers.

A close analysis of the historical perspective of these cases further show that, these cases arose in a period during the last days when the English East India Company was at the helm of affairs in India. English East India Company, being a trading company, had to indulge in futures trading and at times into options trading to keep its profitability up. Hence the English Courts could not have turned a blind eye to the necessity of keeping these contracts legal. Even while the courts found on facts that such a contract, which has already stated, have all the trappings of a modern day options contract, was a wagering agreement. It was also consistently held that an action might be maintained on a wager. However, such a contract is enforceable if it was not against the interest or feelings of third persons did not lead to indecent evidence and was not contrary to public policy.

Second Phase: From 1848 to 1917: Prohibition Days

In 1848, the Gaming Acts were passed and subsequently the Indian Contract Act, 1872 incorporated a ban on wagering agreements in Section 30 of the said Act. The anti-gaming movement[11] in England that culminated in the passing of Gaming Act, 1845 also found its resonance in India, whose governance was taken over from the English East India Company by the British Government in 1848. In 1848 itself, the Gaming Act was introduced in India in the model of English Gaming Act. Act 21 of 1848 named an Act for Avoiding Wagers, 1848 was passed by the Indian Legislature. The said Act was based principally on Section 18 of the English Gaming Act of 1845, and it was repealed by the Contract Act, 1872. During this period, the Indian Courts followed the legislative intention and the English Courts by taking a position that when a certain class of agreement has indisputably been treated as a wagering agreement in England it ought to receive the same treatment in India.

However, it was during this period, that the English Courts started holding that contracts collateral to the wagering agreements are legal and hence enforceable. Hence in *Pringle* v. *Jafar Khan*[12] wherein an agent who paid the amount of betting to the principal was allowed to recover the same from the principal, holding that:

> There was nothing illegal in the contract; betting at horse-races could not be said to be illegal in the sense of tainting any transaction connected with it. This distinction between an agreement which is only void and one in which the consideration is also unlawful is made in the Contract Act. Section 23

[11] During the 1830's, a concerted effort was made by various anti-gambling groups to demand legislation. Well publicised betting frauds, the publication of anti-gambling literature or fictional literature which portrayed lower class gambling as immoral (such as Nimrod's Anatomy of Gaming), resentment at the corrupt lotteries held from 1793, and the mass losses of the South Sea Bubble affair in 1720 culminated in House of Lords setting up a Select Committee on Gaming in 1844 and the introduction of Gaming Act, 1845: See http://www.gamblingconsultant.co.uk/articles/a-history-of-gambling-in-the-uk-until-1960, accessed on 27.09.2015 at 11.13 hrs.

[12] (1883) I.L.R. 5 All. 443.

> points out in what cases the consideration of an agreement is unlawful, and in such cases the agreement is also void, that is, not enforceable at law. Section 30 refers to cases in which the agreement is only void, though the consideration is not necessarily unlawful. There is no reason why the plaintiff should not recover the sum paid by him…[13]

Later in *Beni Madho Das* v. *Kaunsal Kishor Dhusar*[14] the plaintiff who lent money to the defendant to enable him to pay off a gambling debt was given a decree to recover the same from the defendant. Similarly in *Shibho Mal* v. *Lachman Das*[15], an agent who paid the losses on the wagering transactions was allowed to recover the amounts he paid from his principal.

Following these cases, in 1901 itself, the Privy Council, in *Kong Lee Lone and Company* v. *Lowjee Nanjee (Rangoon),*[16] after examining Section 30 of Indian Contract Act had held that two parties may enter into a formal contract for the sale and purchase of goods at a given price and for the delivery at a given time, but if the circumstances are such as to warrant a legal inference that they never intended any actual transfer of goods at all, but only to pay or receive money between one another accordingly as market price of the goods should vary from the contract price at the given time, that is not a commercial transaction at all, but a wager on the rise or fall of the market. In this case, the Privy Council examined the classes of the contract between the parties and held that there is a common intention to wager considering the fact that out of the two classes of contract entered into

[13]*Id* at p. 445.
[14](1900) I.L.R. 22 All. 452.
[15](1901) I.L.R. 23 All. 165.
[16] [1901] UKPC 26 (13 June 1901).

between the parties to the said suit, the consideration of the promissory notes sued was a number of wagering agreements within the meaning of the Indian Contract Act and hence void. This stand brought out the category of instruments that are currently classified as swaps[17] from the purview of law and made them void and un-enforceable by law. At the same time, the law in a way recognised that futures contract, with an intention to buy and sell, at the future date, will not be considered as a wager.

Thus it can be seen that the general trend of the second phase was that most financial derivative transactions of this period, characterised by *Badla* and futures transactions in opium and cotton were held to be wagers and hence pushed off to the grey market. The courts also started a new trend of recognizing as valid, collateral agreements which were entered for the purpose of facilitating the contracts which were termed as wagering agreement. In this phase itself, the courts started giving legal recognition to a pure futures contract as legal, and the contracts which had options and swaps element in it were considered as wager and hence were declared void.

Third Phase: From 1917 to 1950's: The Partial Reopening

In fact the seeds of third phase was marked with the decision of *Kong Lee Cone*[18] itself, but the same was clearly established in 1917 when in *Bhagwandas Parasram (a firm)* v. *Burjorji Ruttonji Bomanji since deceased, (now represented by*

[17] See Chapter II for a detailed discussion on swaps.
[18] *Supra.*n. *16.*

Dulichand Shivlal) (Bombay)[19], the Privy Council held that speculation does not necessarily involve a contract by way of wager and to constitute such a contract a common intention to wager is essential. Privy Council, in this case, clearly set a distinction between speculative investments and contracts of wager. According to the Privy Council, only where there was a common intention of wager, a contract would become wager and therefore void. Where there was one sided speculation, these contracts are enforceable and the plaintiff can recover the amount from the defendant. [20]

Subsequently in *Md. Gulam Mustafakhan* v. *Padamsi*[21], where two partners entered into a contract of wager with a third party and one partner had satisfied his own and his co- partner's liability under the contract, the Hon'ble Nagpur High Court held that the partner who paid the amount could legally claim the other partner's share of the loss. The Court held that Section 30 of the Indian Contract Act does not affect agreements or transactions collateral to wagers.[22]

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[19] [1917] UKPC 97 (26 November 1917).

[20] The facts of the case are as follows: The plaintiffs were a large firm carrying on mercantile business in Bombay and the defendant was a speculator. In June and July 1910 the defendant instructed the plaintiff to sell for him several lots of linseed amounting in all to 4000 tons for September delivery. On the strength of this order, the plaintiff sold linseed to this amount by separate contracts to 39 buyers. Though the transactions took the form of sales by defendant to the plaintiffs followed by resale by the plaintiffs to 39 buyers, the plaintiffs acted throughout as mercantile agents (Pakkaadatias), and to secure against them against loss, the defendant was made to deposit Rs. 61,000/- as margin money with the plaintiff. The market went against the defendant, and at the end of August, the plaintiff asked him, either to give delivery of the linseed or to authorise them to purchase linseed on his behalf. The defendant had neither of these, and therefore the plaintiff, acting within their rights, discharged their obligation to the 39 buyers by delivering 300 tons of linseed, and by making cross contracts, and paying differences as to the balance of linseed as a result Rs. 90,000/- was due from the defendant to the plaintiff. When the plaintiff sued the defendant for recovery of this money, the defendant set up a claim that the contract being a wagering contract is void ab initio and he is not liable to make payments on the said contract.

[21] A.I.R. 1923 Nag. 48.

[22] *Id* at p. 49.

An analysis of these decisions in the historical context would show that during the 1900's the British trade had got a huge competition from the European and US counter parts. In fact, this period saw the financial markets turning to be a major player in the world economy. The two World Wars needed huge funds and the business needs of the time might have forced judicial thinking into finding of ways to recognise these contracts, so that financial innovation and flow of funds is not hampered by the legislative propositions of an earlier period. Thus evolved settling the principle that a wagering agreement was only void, but not illegal, and therefore a collateral contract could be enforced. It may be noted in this context that futures trading in raw Jute and Jute goods began in Kolkata with the establishment of the Calcutta Hessian Exchange Ltd. in 1919, and futures markets in wheat were in existence at several centres in Punjab and Uttar Pradesh; the most notable among them being the Chamber of Commerce at Hapur, which was established in 1913. Futures market in Bullion began in Mumbai as early as 1920. The volumes of trade in these derivatives markets were reported to be extremely large during this period. All this would show that during this third phase, the futures market thrived in India on account of judicial recognition of collateral contracts, and recognition of futures contract as legal.

<u>Fourth Phase: The Regulation Phase</u>

The Socialistic fervour of the Nehruvian era in the first few decades of Independence marked the beginning of this new phase in the derivative regulation. Right from 1930's itself the British rulers of India felt that the derivatives trading in food commodities were responsible for the inability of the government to control its flow. In The Defence of India Act, 1935, there were provisions aimed in part to restrict and directly control food production. This included the ability to restrict or ban the trading in derivatives on those food commodities. With this, futures trading became subject to restrictions/prohibitions from time to time. After Independence, the Union Government enacted the Forward Contracts (Regulation), 1952. This Act provided for prohibition of options in commodities, and the regulation and prohibition of futures trading. By the mid-1960s, the Government imposed a ban on derivatives contracts on most commodities, except very few not so important commodities like pepper and turmeric. The apprehensions about the role of speculation, particularly under scarcity conditions, prompted the Government to continue the prohibition till very recently[23].

In 1959, in *Gherulal Parakh* v. *Mahadeodas Maiya And Others*[24], the Hon'ble Supreme Court of India considered the question whether an agreement of partnership with the object of entering into forward contracts for the purchase and sale of wheat with two other firms, was illegal within the meaning of Section 30 of Indian Contract Act, 1872. The Hon'ble Supreme Court, after considering the various legal texts based on Indian Contract Act, 1872 as well as Gaming Acts of 1845 and 1892, which laid down the law relating to such contracts in England, held that at common law, wagers were not illegal, and were only made null and void by the statutory provision. Hence a partnership entered into for a collateral purpose and not for a wagering agreement will be enforceable in law.

[23]See Suchismita Bose, "The Indian Derivatives Market Revisited", *Money & Finance*, (ICRA Bulletin), (Jan-Jun 2006), at p. 89.

[24] A.I.R. 1959 S.C. 781, 1959 S.C.R. Suppl. (2) 406.

In the said case, the agreement in question was assailed on the ground that it was void under Section 23 of Indian Contract Act, 1872, and that engaging in forward contracts being speculative, the consideration is opposed to public policy, and hence unlawful and therefore void. The Hon'ble Supreme Court after adverting to the earlier decisions relating to Section 23 of Indian Contract Act, 1872, held that:

> Although the rules already established by precedent must be moulded to fit the new conditions of a changing world, it is no longer legitimate for the Courts to invent a new head of public policy. A judge is not free to speculate upon what, in his opinion, is for the good of the community. He must be content to apply, either directly or by way of analogy, the principles laid down in previous decisions. He must expound, not expand, this particular branch of the law.[25]

Even though the contract is one which *prima facie* falls under one of the recognised heads of public policy, it will not be held illegal unless its harmful qualities are indisputable[26]. There upon the court moved forward to examine each of these individual cases and again coming back to wagering agreements held:

> Courts under the common law of England till the year 1845 enforced such contracts even between parties to the transaction. They held that wagers were not illegal. After the passing of the English Gaming Act, 1845 (8 & 9 Vict. c. 109), such contracts were declared void. Even so the Courts held that though a wagering contract was void, it was not illegal and therefore agreement collateral to the wagering agreement could be enforced. Only after the enactment of the Gaming Act, 1892 (55 Vict. c. 9), the collateral contracts also became unenforceable by reason of the express

[25] *Id* para 44.
[26] *Id para* 44.

words of that Act. Indeed, in some of the decisions cited *supra* the question of public policy was specifically raised and negatived by Courts…. It is therefore abundantly clear that the common law of England did not recognise any principle of public policy declaring wagering agreements illegal. The legal position is the same in India. The Indian Courts, both before and after the passing of the Act 1 of 1848 and also after the enactment of the Contract Act have held that the wagering agreements are not illegal and the collateral contracts in respect of them are enforceable.[27]

Thereafter the Hon'ble Supreme Court summarized the position as regards to public policy in respect to such agreements:

To summarize: The common law of England and that of India have never struck down contracts of wager on the ground of public policy; indeed they have always been held to be not illegal notwithstanding the fact that the statute declared them void. Even after the contracts of wager were declared to be void in England, collateral contracts were enforced till the passing of the Gaming Act of 1892, and in India, except in the State of Bombay, they have been enforced even after the passing of the Act 21 of 1848, which was substituted by s. 30 of the Contract Act. The moral prohibitions in Hindu Law texts against gambling were not only, not legally enforced but were allowed to fall into desuetude. In practice, though gambling is controlled in specific matters, it has not been declared illegal and there is no law declaring wagering illegal. Indeed, some of the gambling practices are a perennial source of income to the State. In the circumstances it is not possible to hold that there is any definite head or principle of public policy evolved by Courts or laid down by precedents which would directly apply to wagering agreements. Even if it is permissible for Courts to evolve a new head of public policy under extraordinary circumstances giving rise to incontestable harm to the society, we cannot say that wager is one of such instances of

[27] *Id para* 64.

> exceptional gravity, for it has been recognised for centuries and has been tolerated by the public and the State alike. If it has any such tendency, it is for the legislature to make a law prohibiting such contracts and declaring them illegal and not for this Court to resort to judicial legislation[28].

Again on the question of immorality of these transactions, the Hon'ble Supreme Court held:

> Decided cases and authoritative text-book writers, therefore, confined it, with every justification, only to sexual immorality. The other limitation imposed on the word by the statute, namely; "the court regards it as immoral ", brings out the idea that it is also a branch of the common law like the doctrine of public policy, and, therefore, should be confined to the principles recognised and settled by Courts. Precedents confine the said concept only to sexual immorality and no case has been brought to our notice where it has been applied to any head other than sexual immorality. In the circumstances, we cannot evolve a new head so as to bring in wagers within its fold.[29]

In 1956, SCRA was enacted. In 1969 by virtue of notification[30] issued under Section 16 of the said Act, the Central Government banned with immediate effect all forward trading in shares at all the stock Exchanges in the country by declaring:

> No person, in the territory to which the said Act extends, shall, save with the permission of the Central Government, enter into any contract for the sale or purchase of securities other than such spot delivery contract or contract for cash or hand delivery or special delivery in any securities as is permissible under the said Act and the rules, bye laws and regulations of a recognised Stock Exchange.

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[28] *Id para* 64.
[29] *Id para* 69.
[30] No. S.O. 2561 dated June 27, 1967.

However, it was directed with regard to the forward contracts which remained outstanding as on the date of the said notification that these could be closed or liquidated in the normal manner.

Later in *Shivnarayan Kabra* v. *State of Madras*[31], the Hon'ble Supreme Court had occasion to deal with applicability of S. 15 r/w S. 21 of FCRA which imposed penal liability of any person trading in forward contracts without being member of a recognised association. The contention of the appellant was that contracts in this case were not really meant for delivery of goods but were speculative in character. The Court, after applying the mischief rule[32], held that:

> …the Act was passed in order to put a stop to undesirable forms of speculation in forward trading and to correct the abuses of certain forms of forward trading in the wide interests of the community and, in particular, the interests of the consumers for whom adequate safeguards were essential. In our opinion, speculative contracts of the type covered in the present case are included within the purview of the Act.

What makes the case contextual to our present discussion is that the court acknowledged the need for the legislation by referring to the following passage from the report of expert committee to which the Forward Contracts (Regulation) Bill was referred to prior to its enactment, to approve the concerns behind passing of the statute as valid:

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31 1967 KHC 613, A.I.R. 1967 S.C. 986, 1967 Cri. L.J. 946, 1967(1) S.C.R. 138.

32 The mischief rule was established in Heydon's Case [1584] EWHC Exch J36. Under the mischief rule the court's role is to suppress the mischief the Act is aimed at and advance the remedy.

To the extent to which forward trading enables producers, manufacturers and traders to protect themselves against the uncertainties of the fixture, and enables all the relevant factors, whether actual or anticipated, local or international, to exercise their due influence on prices, it confers a definite boon on the community, because, to that extent, it minimises the risks of production and distribution and makes for greater stability of prices and supplies. It thus plays a useful role in modern business. At the same time, it must be admitted that this is an activity in which a great many individuals with small means and inadequate knowledge of the market often participate, in the hope of quick or easy gains and consequently, forward trading often assumes unhealthy dimensions, thereby increasing, instead of minimising the risks of business. There are forms of forward trading for example, options, which facilitate participation by persons with small means and inadequate knowledge. ......It is, therefore, necessary to eliminate certain forms of forward trading, and permit others under carefully regulated conditions in order to ensure that, while producers, manufacturers and traders will have the facilities they need for the satisfactory conduct of their business the wider interests of the community, and particularly, the interests of consumers, will be adequately safeguarded against any abuse of such facilities by others.[33]

In *Firm of Pratapchand Nopaji* v. *Firm of Kotrike Venkata Setty and Sons*[34] the Supreme Court again had occasion to consider the validity of a contract of agency for the purpose of entering into what is known as *Badla* transactions, which involves speculations on the rise and fall in the prices of goods in the market[35].

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[33] *Id* at pp. 3-4.
[34] A.I.R. 1975 S.C. 1223, 1975 KHC 565, 1975(2) S.C.C. 208.
[35] The defendants are big merchants and have been carrying on trade outside Dhone, even in places like Bombay. They wanted to do the business of purchasing and selling groundnut seeds and oil seeds in Bombay market and for this purpose engaged the plaintiffs as commission agents to contact with Bombay Commission Agents, who were entering into contracts with customers for

The Court held:

> If an agreement is merely collateral to another or constitutes an aid facilitating the carrying out of the object of the other agreement which though void, is not in itself prohibited, within the meaning of Section 23 of the Contract Act, it may be enforced as a collateral agreement. If on the other hand, it is part of a mechanism meant to defeat what the law has actually prohibited, the Courts will not countenance a claim based upon the agreement because it will be tainted with an illegality of the object sought to be achieved which is hit by Section 23 of the Contract Act. It is well established that the object of an agreement cannot be said to be forbidden or unlawful merely because the agreement results in what is known as a "void contract". A void agreement, when coupled with other facts, may become part of a transaction which creates legal rights, but this is not so if the object is prohibited or *mala in se.*[36]

purchasing or selling groundnut seeds and custom oil seeds, according to the orders of the defendants which the plaintiffs were communicating to them. The Bombay commission agents used to give intimation to the plaintiffs of the fact of having executed the orders (the contracts of sale or purchase) and the terms, the rate, etc., of the contracts. The plaintiffs were immediately communicating the information to the defendants. The business was according to the custom prevailing in the Bombay Market, viz. the custom of *Badla*. The defendants not only agreed in general to abide by the custom of *Badla*, but specifically consented to every such *Badla*. At the request of the defendants the transactions were settled after undergoing a few *Badla*. Such settlement were beneficial to the defendants as the market was falling and delay would have meant greater loss: when the market was falling the Bombay agents were pressing for cash settlement on pain of declaring them as defaulters which will result in a disability to do any further business. The defendants knew this state of affairs and they realised that a settlement was the only course beneficial to them. So they specifically told the plaintiffs that they must at any cost preserve their reputation in the Bombay market and with plaintiffs. The defendants hence agreed to pay the amount and on their request and on their behalf the plaintiffs paid all amounts due to the Bombay Commission Agents according to the patties sent by the Bombay Agents in respect of the transactions relating to the defendants. The defendants also agreed to pay to the plaintiff interests on the amounts so advanced by the plaintiffs for payment to the Bombay agents. The Bombay Commission agents were sending patties of transaction to plaintiffs. As already stated, these payments were made at the request of the defendants to repay all such amounts to the plaintiffs with interest. The extracts of the accounts filed with the plaint show the transaction and the amount paid by the plaintiffs at the request of and on behalf of the defendants. The defendants refused to honour the transactions claiming that these are speculative contracts and therefore illegal and not enforceable.

[36]*Id* at para 7.

In this case, the court held that the contract between the plaintiff and defendant was not wager. At the same time, the court held that where a collateral contract to a wager is tainted with illegality, and hence unenforceable, the same cannot be enforced relying on the decision of *Gherulal Parakh's* case. The Hon'ble Supreme Court found that even in *Gherulal Parakh's* case, the harmful effects of permitting such illegal contracts, in terms of injury to the public at large are evident and undisputable.

It can be seen that during this period, interest rate swaps and forward contracts were considered as void as being statutorily prohibited. The Courts would not enforce these contracts, if the transactions which directly relate to these contracts fail. However, the courts were open to the fact that such instruments were being used by businesses for trade. Hence while keeping with the statutory position, the Courts refused to recognise the contracts of these instruments as such and have declared the action brought by one of the parties to such instruments as not maintainable, they devolved the mechanism of "Collateral transactions" and recognised the presence of these instruments obliquely. At the same time, the courts also did not hesitate to refuse to recognise the collateral contracts, if these collateral contracts themselves were found to be illegal.

This discussion brings out the judicial reasoning about transactions on monetary instruments such as financial derivatives that was predominant during the period upto 1980's. Three points evolved from this discussion:

1. Law considered financial derivatives are wagering agreements.

2. They were so considered, not because they were opposed to public policy or were immoral but because statute said that they are void.
3. Despite considering these instruments as wagering agreements and hence void, the law did not hesitate to recognise collateral agreements formed to transact in such agreements as valid.

__Fifth Phase: Liberalisation__

During 1990's the Indian economic scenario entered a phase which is popularly known as Liberalisation, Privatisation and Globalisation[37] Phase. During this phase, India signed General Agreement on Trade and Tariff's[38] to enter the World Trade Organisation[39]. The World Bank and United Nations Conference on Trade and Development[40] submitted a joint report to the Government of India recommending revival of futures trading in farm commodities and their products to render trade in such commodities competitive in the world markets after the envisaged removal of trade and non-trade barriers. The Government of India also set up the Kabra Committee in 1993 to review the futures trading for other commodities. As an outcome of these developments, the SCRA was amended in 1999[41] and derivative trading was allowed.

However, the judicial recognition of derivative instruments delayed as no cases involving these transactions came up for judicial interpretation. One main reason

[37] Popularly known as LPG.
[38] Known as GATT.
[39] Known as WTO.
[40] Known as UNCTAD.
[41] Act 31 of 1999, which inserted S. 18A into the Act.

was the emphasis on arbitration as a means of dispute resolution that evolved during the liberalisation era. Moreover, since the modern day financial instruments become more and more complex, the judicial mind was also in favour of leaving the complex technicalities involved in these instruments to the expert arbitrator. The Hon'ble High Court of Madras in *Sundaram Brake Linings Ltd.* v. *Kotak Mahindra Bank Ltd.*[42] took a similar stand when it had the occasion to go through similar contentions, in a case relating to financial derivatives. The main question was whether the arbitration clause in I.S.D.A. Master Agreement was enforceable or not. It was argued on behalf of the petitioner that I.S.D.A. Master Agreement is void *ab-initio* on the ground that it is opposed to public policy and therefore hit by Section 23 of the Indian Contract Act, and also that it being a wagering agreement is hit by Section 30 of the Indian Contract Act. On the other hand, on behalf of the respondent, it was contended that the I.S.D.A. Master Agreement is neither a wagering agreement nor an agreement opposed to public policy and that it is authorised by the RBI and adopted and entered into by several nationalised banks. The Hon'ble High Court of Madras, acknowledging that it is a grey area, thought it fit not to enter into the said grey area and left it to the arbitrator to decide on that question finding that under S. 8 of the Arbitration and Conciliation Act, 1996, the arbitrator has the power to decide that issue and therefore judicial authority cannot go into the question as to whether the agreement is null and void, inoperative or incapable of being performed.

[42] 2008 (7) M.L.J. 1296.

In 2009, the Hon'ble High Court of Madras had another occasion to go into the same question as to whether options contract violates S. 30 of Contract Act and RBI guidelines in *State Bank of India* v. *M/s. P.R.P. Exports.*[43] However, the court only considered the arbitration clause in the I.S.D.A. Agreement and did not go into the substantive questions posed regarding the validity of the agreement.

It was only in *M/s. Rajshree Sugars & Chemicals Limited* v. *M/s Axis Bank Ltd & others*[44] the Hon'ble High Court of Madras seized the opportunity to consider the nature of the derivative transactions. It is interesting to note that this case brought to fore almost all issued highlighted by Alastair Hudson.[45] The dispute in this case was with regard to an I.S.D.A. Master Agreement entered into by the petitioner with the UTI Bank Limited.[46] In pursuance of the I.S.D.A. Master Agreement dated 14.5.2004, at least 10 deals[47] were struck between the plaintiff and UTI Bank and 9 out of those 10 deals have already matured without any dispute on either

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[43]http://indiankanoon.org/doc/699214/ accessed on 15.05.2015 at 21.39 hrs.

[44] 2011 KHC 2472: A.I.R. 2011 Mad. 144.

[45]See Alastair Hudson, *Law on Financial Derivatives*, Sweet & Maxwell, London, (2nd Ed., 1998).

[46] Renamed as the Axis Bank Ltd.

[47] The disputed deal was a USD-CHF (U.S.Dollars-Swiss Franc) Option Structure entered into by the one P.K.Viswanathan on behalf of the plaintiff on 22.6.2007 with the UTI Bank. The structure of the deal was as follows:-

1. The plaintiff would receive USD 100,000 on 23.6.2008 if spot never trades at 1.2385 from trade date namely, 22.6.2007 till fixing date namely; 19.6.2008.
2. During the reference period from 22.6.2007 to 19.6.2008, if USD-CHF never touches 1.1250 and 1.2385 and if it ever touches 1.2385, there is no exchange of principal, but if it ever touches 1.1250 and never touches 1.2385, the plaintiff should buy USD 20 million against paying CHF at 1.3300. During the reference period from 22.6.2007 to 15.6.2009 if USD-CHF never touches 1.1200 and 1.2385 or if it ever touches 1.2385,there is no exchange of principal, but if it ever touches 1.1200 and never touches 1.2385, the plaintiff should buy USD 20 million against paying CHF at 1.3300.
3. If the USD-CHF touches the level of 1.2385 ever during the period starting from 22.6.2007 to 15.6.2009, then the entire structure gets knocked out with no subsequent liability and the plaintiff would receive USD 100,000 on the spot date of touch. However if spot touches 1.2325, then the plaintiff would receive instant payment of USD 100,000 though the structure will not get knocked out.

side. In terms of the above deal, entered into on 22.06.2007, the defendant paid USD 100,000 to the plaintiff on 27.06.2007. The plaintiff received the said amount. However, after 6 months, the plaintiff sent a letter dated 12.12.2007 claiming that the entire structure as per the contract dated 22.6.2007 got knocked out with no liability to either of the parties. But, by a reply dated 07.01.2008, the Bank challenged the claim and contended that the contract was still alive and that the Bank was prepared to work out suitable risk mitigation structures. Dissatisfied with the stand taken by the bank, the plaintiff filed the above suit to declare this derivatives contract as void *ab initio*. The questions that were raised before the Hon'ble High Court of Madras were the following:

1. Whether the said contract was a wager and hence hit by S. 30 of Indian Contract Act?
2. Whether the said contract is opposed to public policy and hence hit by S. 23 of Indian Contract Act?
3. Whether the person who entered into contract on behalf of the company had authority to do so?

The Court extensively considered the history of the derivatives trading and held that the essential features of a wagering agreement as formulated by the English Courts were:

1. There must be 2 persons or 2 sets of or 2 groups of persons holding opposite views touching a future uncertain event. It may even concern a past or present fact or event.

2. In a wagering agreement, one party is to win and the other to lose upon the determination of the event. Each party must stand either to win or lose under the terms of the contract. It will not be a wagering agreement if one party may win but cannot lose or if he may lose but cannot win or if he can neither win or lose.
3. The parties have no actual interest in the occurrence or non-occurrence of the event but have an interest only on the stake.

Applying the above guidelines the court held that the contracts in *Grizewood* v. *Blane*[48] and *Richards* v. *Starck*[49] were considered to be wagers as there was an understanding of the parties that the subject matter should neither be transferred nor paid for on the settlement day, but that on that day, one party should pay to the other, the difference between the market price on that day and the price on the day of the contract. Where a series of contracts for the sale and purchase of shares gave the buyer an option to demand delivery on payment of an extra sum, it was held that they were wagers, since it was only when the option was exercised, they would become genuine transactions of sale and purchase. However, the Court found that all speculation does not amount to wager and laid down the following principles to distinguish wagering agreements with other legally enforceable contracts:

1. If one party to the transaction undertakes a real liability to give or take delivery, the mere fact that the other party intends by a subsequent

[48] (1851) 11 C.B. 526.
[49] [1911] 1 K.B. 296.

transaction to arrange that delivery under the first transaction shall not take place, does not turn the transaction into a wager.

2. A genuine purchase of shares followed by a separate and genuine sale creates enforceable obligations, even though the original purchaser never intended to take delivery of the shares and was in fact merely speculating upon their value. However, if there is an agreement to the effect that sales and purchases of stocks and shares shall not be actually carried out but shall end only in the payment of differences, the transaction will be a wager notwithstanding the fact that the ostensible terms of business gave a right to insist on delivery.
3. Though every wagering agreement is speculative in nature, every speculation need not necessarily be a wager. In a wagering agreement, there has to be mutuality in the sense that the gain of one party would be the loss of the other on the happening of the uncertain event which is the subject matter of wager.
4. The mere fact that the parties never intended to take delivery at the end would not also make a transaction a wager.

After extensively considering the dictum of Hon'ble Supreme Court in *Gherulal Parakh* case[50], the Hon'ble High Court of Madras also found that even though a contract of wager is void, it is not opposed to public policy and hence will not come within the ambit of S. 23 of Indian Contract Act, 1872. Thereupon the court delved into the specifics of the impugned contract and found that under the said contract,

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[50] *Supra* n. 24.

there are some contingencies in which USD 100,000 becomes payable by the Bank to the plaintiff, making the plaintiff the gainer and there are other contingencies when the plaintiff becomes obliged to buy USD 20 million at the rate of 1.3300 Swiss Franc per 1 USD from the Bank, making the bank the gainer. It was also found that the payment of USD 100,000 prescribed under the deal is to hedge the plaintiff against the risk of depreciation in the value of USD, comparable to the sum assured under a contract of insurance, though the transaction cannot exactly be compared to an insurance transaction. It was also found that merely because the plaintiff is obliged to purchase USD 20 million at the rate of 1.3300 CHF per Dollar from the bank, and this would put the plaintiff to a huge loss, will not make the transaction a wager, as the contract confers on the plaintiff a right to seek actual delivery and if actual delivery can be compelled, it will not be a wagering transaction. Moreover, the court also found that the records do not show that the plaintiff and the Bank shared a common intention to enter into a wagering transaction. After going through the entire correspondence in the case, the court also found that the person who had entered into transaction on behalf of the plaintiff had the requisite authority to enter into such a transaction, and the court held as follows:

> …three tests are to be satisfied if a contract is to be termed as a wager. The first test is that there must be two persons holding opposite views touching a future uncertain event. The second test is that one of those parties is to win and the other is to lose upon the determination of the event. The third test is that both the parties have no actual interest in the occurrence or non-occurrence of the event, but have an interest only on the stake. The first test

> is satisfied in this case as there are 2 parties. But, the second test may not be satisfied in this case since the plaintiff may not always stand to lose. If the plaintiff loses in the underlying contract on account of currency fluctuation, it may get compensated by the hedging and vice versa. Therefore both parties cannot be taken to be winners or losers in absolute terms. Even if we take for the sake of argument that the first two tests are satisfied in this case, the third test is certainly not satisfied in the case on hand. Both the parties definitely have an actual interest in the rate of exchange hitting a high or low. This is because of the fact that the very intention of the transaction is to hedge an underlying exposure. It is like a contract of insurance, where, on the happening of an uncertain event, the sum assured becomes payable.[51]

Through this decision, the court was laying the foundation stone for legalising derivative transactions in India and bringing the same out of the question whether they are wagering transactions, once and for ever, provided there is an element of hedging and also where both the parties have an actual interest in the trigger value hitting a high or low. The court held that none of the parties can be held to be winners or losers in the absolute sense; where the plaintiff loses, his loss may get compensated by hedging and vice versa. The Court also brought the derivative contract to the level of an insurance contract, which also in fact is a wagering agreement, if looked from one angle, as it speculates on the happening of an uncertain event. The court thereafter went to affirmatively proclaim as follows:

> As a matter of fact, the prices of derivatives is now scientifically determined on the basis of a mathematical model (or formulae) developed by 2 men by name Fischer Black and Myron Scholes in 1973. The formulae itself was named after them, as Black-Scholes Model. The application of the model,

[51] *Id* para 71.

led to the award of the Nobel in Economics. The derivatives prices are determined by feeding certain inputs into this model. These inputs are (i) stock price of the underlying asset (ii) amount of time until expiration (iii) strike price of the option (iv) volatility of the underlying asset (how much it moves up or down during a given period) (v) risk free rate of return (usually the interest rate paid by Government to the banks on guaranteed investments). After Black-Scholes model, several models were developed, the noted among them being the Garman-Kohlhagen model designed to arrive at the price of Foreign Exchange (FX) options. Therefore derivatives transactions ceased to be purely speculative deals, long time ago. The pricing of the deals, follows a scientific pattern on the basis of Financial Mathematics. Just as Actuaries scientifically determine the value of insurance risks and the premium payable, Financial Mathematicians (or Portfolio Managers) evaluate the price of these derivatives. Hence they cannot be termed as wagers.[52]

This was to remove the doubt, if any that remained, as to whether the derivative transactions are still speculative in nature. The court further sealed the question as to whether the derivative transactions are opposed to public policy by holding thus:

> Thus the transactions in derivatives are age old, in so far as commodities and stocks and securities are concerned. These transactions are at least about a couple of decades old in so far as foreign currencies (and forex options) are concerned. Therefore it is futile on the part of the plaintiff to contend that the transactions are either prohibited by law or opposed to public policy. What is expressly permitted by law cannot be held to be opposed to public policy. The Master Circulars issued by RBI from time to time and the Regulations framed by RBI under the FEMA, 1999 permit such transactions. Such transactions have the sanction of law the world over, despite the

[52] *Id* para 81.

> mishaps such as Orange County, Barings Bank, Long Term Capital Management, Lehman Brothers, AIG etc. Admittedly, the Nationalised Banks in our country also offer such products, though their marketing strategy is not so aggressive, on account of conservative outlook. Therefore, the contention of the plaintiff that the deal is opposed to public policy is archaic.[53]

The Court also considered the objection that the transaction violated the RBI and SEBI guidelines and Foreign Exchange Regulations and found that there was no such violation. Moreover, it was also found that the existing regulations permit such transactions. The court held that the SEBI master circular allowed companies to invest in call or put options and even though writing of options is not permitted, zero cost options were permitted[54].

In a way, *M/s Rajshree Sugars* [55] case marked the beginning of a new era in the judicial recognition of these instruments. In this case, the High Court of Madras had the opportunity to examine almost all the grounds in which the derivatives could be assailed and negatived all of these grounds. In fact, this case settled the most contentious issues regarding derivative transactions and moved these transactions from a grey area of law to the clear zone.

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[53] *Id* para 100.
[54] Master Circular bearing No. SEBI/CFD/DIL/CG/1/2004/12/10 dated 29-10-2004, wherein the Securities Exchange Board of India directed all Stock Exchanges to amend the Listing Agreements by replacing the existing clause 49, as quoted in *M/s Rajshree Sugars* Case, *supra* n. 44.
[55] *Supra* n. 44.

Another area where the judicial response was robust was regarding the role of regulatory agencies. In *M/s Rajshree Sugars* Case[56] the Court has considered with approval the recognition given to trading in options by SEBI and RBI. Subsequently in *Kotak Mahindra Bank Ltd*. v. *Hindustan National Glass and Industries Ltd. and others,*[57] the Hon'ble Supreme Court of India had the occasion to consider the applicability of RBI circular on wilful defaulters in respect of a party to a derivative transaction. The core issue in dispute was whether the act of the bank in terming a defaulter in derivative transactions as a "wilful defaulter", enabling the Bank to initiate recovery proceedings under SARFAESI Act[58] is legal. There was a conflict in the decisions of Hon'ble High Court of Bombay and Hon'ble High Court of Calcutta as to the applicability of RBI Master Circular on Wilful Defaulters to defaulters in derivative transactions.

In the case before Hon'ble High Court of Calcutta, appellant-bank sanctioned Derivatives/Forward Contracts facility to Hindustan National Glass & Industries Ltd., upto a limit of Rs.2,00,00,000/- (Rupees Two Crores) only for the purpose of hedging foreign currency exposures. The parties thereto subsequently entered into derivative transactions, for the purpose of hedging adverse foreign exchange fluctuations, in which a sum of Rs.2,43,12,000/- (Rupees Two Crores Forty Three Lakhs and Twelve Thousand only) had become due and payable from the said

[56] *Supra* n. 44
[57] 2013(2) A.D. (S.C.) 113, 2013 (2) A.L.D. 72 (S.C.), (2013) 2 CAL. L.T. 1 (S.C.), 2013 (2) C.D.R. 555(S.C.), (2013) 1 Comp. L.J. 225(S.C.), J.T. 2013 (1) S.C. 60, 2013-1-L.W. 785, 2012 (12) SCALE 144, (2013) 7 S.C.C. 369, [2013] 117 S.C.L. 521(SC), (2014) 1 WB.L.R. (SC) 765
[58] Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

company to the appellant bank. The company however did not pay the sum as above. In the meanwhile by Master Circular on Wilful Defaulters, RBI instructed all banks and financial institutions regarding reporting of wilful defaulters to other banks and financial institutions and the measures to be imposed on wilful defaulters by such banks and financial institutions. Consequently, the appellant bank informed Hindustan National Glass and Industries Ltd. that it had classified the company as wilful defaulter. The Hindustan National Glass and Industries Ltd. countered the said classification by its correspondences with the Bank that it was neither a borrower nor bank a lender, within the meaning of "wilful default" in the Master Circular and therefore, action under the Master Circular cannot be taken against the company. The bank thereupon gave the company a chance to represent its position before the Grievance Redressal Committee of the Bank, and after hearing the company, the Committee upheld the classification of the Company as a "wilful defaulter".

Aggrieved by the said order, the company filed a writ petition before the Hon'ble High Court of Calcutta, where in the Hon'ble High Court of Calcutta *inter alia* held that the Master Circular applied only to lending transactions of a bank or financial institution and as in the foreign exchange derivative transactions between the bank and company, there was no such lending transactions, Kotak Mahindra Bank was not the lender and Hindustan National Glass and Industries Ltd. was not the borrower. Hence it was held that Hindustan National Glass and Industries Ltd. could not be declared as a wilful defaulter in terms of the Master Circular and accordingly no action could be taken against Hindustan National Glass and Industries Ltd under the Master Circular.

On the other hand in a similar before the Hon'ble High Court of Mumbai, *M/s Emcure Pharmaceuticals Ltd.* v. *ICICI Bank Ltd.*[59], the Hon'ble High Court of Bombay held that the very same Master Circular covers the outstanding claims of ICICI Bank Ltd. against Emcure Pharmaceuticals Ltd. arising out of the foreign exchange derivative transactions.

The Hon'ble Supreme Court, after considering the rival contentions as well as the stand of RBI has held that:

> the purpose of the Master Circular being to caution banks and financial institutions from giving any further bank finance to a wilful defaulter, credit information cannot be confined to only the wilful defaults made by existing borrowers of the bank, but will also cover constituents of the bank, who have defaulted in their dues under banking transactions with the banks and who intend to avail further finance from the banks[60].

It was also held that the term "wilful defaulter" in the said Master Circular would mean not only a wilful default by a unit which has defaulted in meeting its repayment obligations to the lender, but also to mean a unit which has defaulted in meeting its payment obligations to the bank under facilities such as a bank guarantee. Hence the court held that on interpretation of the Master Circular, the Master Circular covers not only wilful defaults of dues by a borrower to the bank but also covers wilful defaults of dues by a client of the bank under other banking

[59] Company Petition No. 431 of 2010, decided on 9th December 2011, per S.C. Dharmadhikari, J.
[60] *Supra* n. 57, para 34.

transactions such as bank guarantees and derivative transactions. By holding so, the court struck down the decision of Hon'ble High Court of Calcutta and upheld the view taken by Hon'ble High Court of Bombay.

This decision is important, since in this case, the decision of Hon'ble High Court of Madras in *M/s Rajshree Sugars*[61] case was noted with approval and recognised derivative transactions by banks and further increased the capability of banks to take action against non-funded facilities like derivative transactions also. However, the general approach of the Indian Courts to the derivative contracts is to construe them as instruments that require domain expertise to interpret and leave the interpretation of contractual clauses to domain experts and confining itself to an overseer of arbitration proceedings.

JUDICIAL APPROACH IN THE UNITED STATES OF AMERICA

The approach of courts in the US to these instruments is also noteworthy.

In Korea Life Ins. Co., Ltd. v. *Morgan Guar. Trust Co. of NY*[62] the US Court has held that derivatives transactions at issue were not evil in themselves (malum in se)," and although the parties' attempted to "evade Korean regulation and to enter into an inappropriate transaction may have been questionable. It did not amount to moral turpitude.

[61] *Supra* n. 44.
[62] 269 F Supp 2d 424, 438 [SD NY 2003].

The general trend of the US courts is to give recognition to the contracts in financial derivatives, and to interpret them in accordance with the original intention of the parties.

As opposed to Indian Courts, which leave interpretation of the agreement to arbitrators, the courts in the US interpret the clauses in these agreements themselves. The major area where such interpretation becomes crucial is where one party to the agreement raises a claim of misrepresentation by the other party. In contracts where the parties have agreed that they will not rely on the expertise of the other party, the US Courts have always considered both parties at equal status, and has refused to give judgement in favour of the party which claims to be misled by the other party in a derivative transaction.

For example, in *JP Morgan Chase Bank, N.A.* v. *Controladora Commercial Mexicana S.A.B. De C.V.*[63], the Supreme Court of New York held that the existence of non-reliance clause in the agreement would preclude the parties there to from claiming that there was misrepresentation. It was also held that where parties, particularly sophisticated business entities enter into an arm's- length business transaction, the terms of their contract govern their relationship[64]. In this case, the court had an occasion to consider validity of foreign exchange currency swap contracts. The parties had entered into a contract based on I.S.D.A. Standard form Master Agreement and Credit Support Annex.

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[63] 2010 NY Slip Op 52066(U) [29 Misc 3d 1227(A)].

[64] See *Northeast Gen. Corp.* v. *Wellington Adv., Inc.*, 82 NY 2d 158, 160 [1993].

In *ADM Investor Services Inc*. v. *Mark W. Collins*[65] Court of Appeals of the Seventh Circuit, while considering a Contract of Differences, the Court of Appeal held that a contract does not become illegal just because a party fails to put down a deposit (margin in futures market). The Court further held that failure to post security as required enables the other side to rescind the contract but does not enable the party at fault to earn benefits out of his fault[66].

Similarly, the decisions in *Republic Natl. Bank* v. *Hales*[67] *and CDO Plus Master Fund Ltd*. v. *Wachovia Bank, N.A*[68] also follow this trend. In the former, the District Court New York, USA has interpreted a *non-reliance* clause in an I.S.D.A Swap Agreement and has held that in the existence of such a clause in the agreement the opposite party cannot claim that they have reasonably relied on the expertise of the other party. Similarly in the latter case, the Court had held the parties are bound by the provisions of I.S.D.A. Schedule and Credit Support Annex which are specific to the parties, and one of the parties cannot claim the said agreement to be invalid merely because the standard form of I.S.D.A Master Agreement have been followed. The Court considered the annexure to the I.S.D.A. Master Agreement as agreed after specific negotiation and held that they not boilerplate terms i.e., terms which are relatively standardised clauses that are often agreed with little or no negotiation and found towards the end of an agreement. Similarly in *Gray* v. *Seaboard Sec., Inc.*[69], the court had held that Securities

[65] MANU/FEVT/0452/2008.
[66] *Ibid.*
[67] 75 F Supp 2d 300 [SD NY 1999], affd 4 Fed Appx 15 [2d Cir 2001].
[68] No. 07 Civ. 11078(LTS) (AJP), 2009 WL 2033048, *6 [SD NY July 13, 2009].
[69] 14 AD3d 852 [3d Dept]

transactions between parties are duly negotiated contracts, and cannot be looked into from the angle of interpreting a standard form contract, where the focus of the court is protection of the consumer.

The approach of US courts is to view the parties to these instruments at equal terms and the courts generally construe the terms of the contract between parties as valid. In general, the approach of the US court is to uphold the contractual terms[70].

JUDICIAL APPROACH IN UNITED KINGDOM

While on this topic, it would be worthwhile to consider the approach of courts in U.K to these instruments.

In *Titan Steel Wheels Limited* v. *The Royal Bank of Scotland Plc*[71], the High Court of Justice (Queen's Bench Division Commercial Court) had to consider a curious case where the petitioner alleged misspelling of derivative products. The case of Titan was that these products were so unusual and complex that (a) Titan's financial controller had no actual or implied authority to enter into them and the facts were such that the Bank knew this; (b) the Bank advised Titan to take these products which were in fact unsuitable to its needs and thus is liable in negligence; (c) the Bank had a duty under the FSA rules to deal "fairly" with Titan including a duty to ensure that communications or descriptions of the products were accurate and not misleading and that although the information provided by the Bank contained some health warnings, they did not go far enough. The Court, after going through the

[70] See also *Finance One Public Co. Ltd.* v. *Lehman Bros. Special Fin., Inc.,* No. 00 CIV 6739(CBM), 2001 WL 1543820, * 1 [SD NY December 4, 2001]
[71] [2010] EWHC 211 (Comm):2010 WL442366

terms of the contract, came to a conclusion that where there are specific terms which exclude responsibility, the bank or investment advisor, which has been expressly retained to furnish advice, would not be liable for the failed investment advice. It was also held that where the parties have purported to allocate by contract their respective roles and the risks involved in their relationship, it will in the normal run to preclude any wider obligation arising from a common law duty of care. In arriving at this decision, the Court relied on *Vales Holdings* v. *Merrill Lynch International Bank*[72], *Henderson* v. *Merrett*[73] and *IFE Fund* v. *Goldman Sachs Int.*[74]

In *Peekay* v. *Australia and New Zealand Banking Group*[75] a bank employee had misrepresented the nature of an investment product. But the relevant terms and conditions contained provisions to the effect that the customer knew the true nature of the contract he was entering into and had determined that it was suitable. There was also a notice that the customer had taken independent advice and was not relying on the bank. The Court, after relying on the decisions in *Colchester Borough Council* v. *Smith,*[76] held that where parties express an agreement of that kind in a contractual document, they cannot subsequently deny the existence of the facts and matters upon which they have agreed, at least so far as it concerns those aspects of their relationship to which the agreement was directed. The contract itself gives rise to an estoppel.

[72] [2004] EWHC 2471*(*Comm*)*.
[73] [1995] 2 AC 145.
[74] [2007] EWCA Civ 811.
[75] [2006] 2 Lloyd's Rep. 511.
[76] [1991] Ch 448, affirmed on appeal [1992] Ch 421.

Similarly *Standard Chartered Bank* v. *Ceylon Petroleum Corporation*[77] is a case in which when the claimant (plaintiff) bank claimed the remaining payments which are due to it under the terms of a derivative transaction, the counterparty respondent put up a counter claim stating that (a) it had no capacity to enter into derivatives transactions being outside the scope of its general objectives, (b) the officials who entered into the transactions on behalf of the respondents do not have the actual or ostensible authority to enter into the transactions, (c) the obligations of the respondent got washed away by a supervening impossibility, since by a letter from the Central Bank of Srilanka, the further performance of payment obligations under the transactions were rendered unlawful. It also set up a counter claim for damages on account of loss due to breach of fiduciary duty, to advice the respondent, when it had made misrepresentations. In fact, the disputed transactions were part of a series of transactions entered into between the respondent, which is a state owner importer of petroleum products. In an attempt to protect itself from the rise in oil price, the respondent began to enter into oil derivative transactions with the claimant from 2007. Between February 2007 and October 2008, respondent entered into about 30 such transactions, including 10 transactions with claimant. The dispute arose in two transactions, where respondents incurred huge loss. The High Court of Justice (Queens Bench Commercial Division) has held that since there was no breach of obligations by claimant and there was no misrepresentation, the parties are bound to honour terms of their contract.

[77] 2011] EWHC 1785 (Comm):2011 WL 2649362.

In *City Index Ltd (trading as Fin Spreads)* v. *Romeo Baldacci*[78], the England and Wales High Court (Chancery Division) while approving a claim on a debt incurred by the defendant in “spread betting”[79] on the price of heating oil over a period of two and a half years, held that spread betting is regulated by the Financial Services Authority, and even while holding that spread betting is essentially betting, the court considered the betting contract enforceable as it is the will of the parties.

Thus, it can be seen that the general trend of UK courts is to uphold the contractual terms, and where ever the banks or financial institutions, which sell the contracts have expressly excluded their responsibility, the courts are not inclined to find a breach of duty where the advice fails due to change in commercial conditions[80].

SUMMING UP

It can be seen that the Indian judicial response to the contracts, which are currently known as derivative transactions have passed through five phases. In the first phase, the courts were applied basic principles of contract and recognised these contracts. The courts found that even if it were wagers, the public policy in England or in India did not require to make these contracts void. In the second phase, these were found to be wagers and were considered to be void, especially in

[78] [2011] EWHC 2562 (Ch).
[79] Spread betting is defined in *Spreadex* v. *Battu* [2005] EWCA Civ 855 at [2]-[4] as follows: "Spread betting is not so much or not merely a bet, although it can be described as such, as a form of contract for differences. It enables a customer to take a position on a market (or an event) for a very small stake… The spread betting operator who accepts these trades does not bet against the customer, but lays off the trade elsewhere. Ultimately, I suspect, the trade is accumulated in some form of derivative transaction on a futures exchange, but I do not know. The operator, however, by laying off the bet elsewhere, seeks to profit by means of the spread. The means by which it does that, and the terms on which it does that, however, are not a matter for the operator's customer: or, in the present case, have the applicable terms been disclosed.”
[80]See also *Sucden Financial Limited (Formerly Sucden (UK) Limited)* v. *Fluxo-Cane Overseas Limited, Manoel Fernando Garcia*, [2010] EWHC 2133 (Comm): 2010 WL 3166471.

the light of S.30 of Indian Contract Act. In the third phase, though the main contracts were found to be void, the courts were willing to recognise collateral contracts, as they are not wagers. This way, the courts were recognising that though wagers, these contracts were entered by both parties in their free will and one party should not be allowed to unjustly enrich claiming that the entire contract and its collateral arrangements are unenforceable. Fourth phase was marked with stricter legislative provisions banning products which are presently categorised as derivatives, and the courts followed the legislative directive and refused to give effect to these contracts. In the fifth and on-going phase, the courts have explicitly recognised the derivative transactions. Starting from *Rajshree Sugars* case[81], the courts have straight away addressed the issue whether these contracts are wagers, and found that they are not wagering agreements. On comparison, it can be seen than at the level of individual players; both the US and the UK courts have been taking a strictly contractual approach. At this level, the courts construe contracts strictly, so that the terms of the contract are given importance and effect. It can be seen that Indian courts are also taking a similar approach. From the angle of institutional regulation, it can be seen that the approach of courts in these entire jurisdiction is in recognising institutional regulators and following an approach of non-interference in their regulatory duties, recognising their domain expertise.

The above analysis also brings out the need for a specialised judicial body in India, with expertise to deal with complex contractual issues, with deep financial implications, which can help the parties to take a decision in case of real conflict.

[81] See *supra* n. 44.

Arbitration, and for that matter all alternative dispute resolution mechanisms which are preferred by Indian business entities that engage in derivative transactions have the danger of taking an ad-hoc approach in providing solutions. Though arbitral tribunals may be effective in settling technical matters, their effectiveness in properly applying the legal principles and evolving new principles is minimal. Hence there is a need for Specialised Judicial bodies, with adjudicatory power, to decide on matters relating to derivative contracts. These bodies can also be entrusted with the task of judicial review over regulators.

FSLRC has recommended creation of Financial Sector Appellate Tribunal (FSAT), with jurisdiction to review all decisions passed by the financial regulators, and can also strike down subordinate legislation (regulations) if they are ultra vires the parent statute.

There have been dissenting opinions[82] from the regulators regarding this power, as the regulators do not want judicial interference in policy matters. However, it is ideal that the specialised judicial body envisaged by FSLRC, which has the primary duty to pass judicial orders based on subordinate legislations should also have the power to strike down subordinate legislations, which are found to be *ultra vires* the parent statute. This power as envisaged by FSLRC is similar to the power of

[82] See Talk by Dr. Raghuram Rajan at the First State Bank ‘Banking and Economic Conclave’ held at Mumbai on June 17, 2014, entitled “Financial Sector Legislative Reforms Committee Report (FSLRC): What to do and when?” available in https://rbi.org.in/SCRIPTS /BS SpeechesView.aspx?*Id*=900, accessed on 23.05.2016 at 22.40 hrs. *See also,* “The Curious case of MCA: A live example that illuminates the Rajan Critique of FSLRC” by Pratik Dutta available in http://www.derivativesinvesting.net/article/ 5065111218/the-curious-case-of-the-mca-a-live-example-that-illuminates-the-rajan-critique-of-fslrc/, accessed on 23.04.2016 at 22.42 hrs, for a contra opinion.

judicial review of High Courts and Supreme Court under the Constitution of India. These judicial bodies shall have special rules of procedure, to enable speedy disposal of the matters, since matters of finance have a sense of urgency, as otherwise financial advantage would be lost.