

HOW TO SQUARE A CIRCLE: EXPLORING THE LEGALITY OF FINANCIAL DERIVATIVES IN INDIA

*Deepaloke Chatterjee & Ranjini Das**

Section 30 of the Indian Contract Act, 1872 makes agreements by way of wager void. In spite of the above provision declaring wagering contracts as void, there has existed for some time now, a practice of entering into derivative contracts in the financial market. Such contracts are especially resorted to when it comes to dealings with foreign exchange on account of fluctuations in the exchange rates. Numerous Indian companies who have made losses due to trading in derivatives, have argued that the contracts the banks entered into with them were illegal, in violation of Reserve Bank of India (“RBI”) guidelines, opposed to public policy and unenforceable, and not binding on them. Under Indian exchange control laws, an Indian corporate, being a person resident in India, can enter into a foreign currency derivative contract only to hedge an exposure to foreign exchange risk and not for speculating and chasing profits. The authors during the course of the present paper will examine the validity of such contracts in light of Sections 30 and 23 of the Indian Contract Act, 1872. The authors will seek to answer the question of whether these companies can at their convenience now state that such contracts are unenforceable or whether this has implications on their past profits.

I. INTRODUCTION

Global markets today have been gripped by the worst economic crisis since the Great Depression of 1929. Throughout September 2008, the world has been witness to a widespread freezing of financial markets. A severe economic crisis has been spreading from the United States of America (*hereinafter* USA or US) to the rest of the world. On September 14, 2008, Lehman Brothers went bankrupt; this incident was closely followed by the absorption of Wall Street’s third largest bank, Merrill Lynch, in the Wall Street, by the Bank of America. On September 22,

* 4th and 2nd Year students respectively, W.B. National University of Juridical Sciences. We wish to acknowledge the comments and assistance received from Mr. Pratik Datta (4th Year, NUJS) and Mr. Sarbajeet Nag (5th Year, NUJS).

investment banks such as Goldman Sachs and Morgan Stanley were forced to convert themselves into bank holding companies. On September 26, the American government dissolved the savings bank Washington Mutual. This was considered by many to be the largest bank failure in the history of USA. Three days later America's fourth largest banking chain Wachovia succumbed to a credit crisis. What is more worrisome is the fact that this crisis is not limited to the USA alone, but has spread its tentacles across the whole of the civilized world. After the fall of British mortgage major, Northern Rock, the British Government introduced regulatory control over the mortgage lending market.¹

This crisis, which has spread to all corners of the world, has not left the shores of India untouched. As is evident, India is no longer insulated from global money markets and it is only natural and obvious that the crises affecting the rest of the world is sooner or later, going to affect India also. Such thought provoking observations compels one to reflect on the causative factors of such unprecedented bank failures.² The growing popularity and the increasing use of financial derivatives has been one of the most noteworthy developments in the sphere of capital markets and the financial services industry during the last few decades. With investors driven by a profit maximizing and a risk minimizing motive, these markets have seen a real flourish. However, it would be wrong to assume that the use of derivative contracts is a new phenomenon; rather, they have been entered into for as long as people have been trading with each other. However as things appear today, the risk minimizing properties of derivatives appear to have waned considerably, and this paper is essentially a critique of this fall from grace.

The present paper investigates the parameters within which financial derivatives are permitted within the Indian legal framework. The first part elucidates the significance of derivative contracts, and provides an outline with regard to what constitutes derivatives. The second part is essentially a discussion relating to the growth of the financial derivative market in India. It should be kept in mind that numerous Indian companies have entered into derivative trading contracts concerning dealings with foreign exchange, with the aim of earning profits on account of fluctuations in the exchange rate. It has been a rather unfortunate practice that in the event, these companies incur losses, they conveniently sidestep their liability by arguing that the contract entered by them with the bank by virtue of which such abovementioned dealings were financed, are wagering agreements

¹ The Telegraph Bureau Reports, *Bailout Goes Bust*, THE TELEGRAPH (Kolkata), September 30, 2008.

² Monty Guild, Tony Danaher, *Meltdown: The Toxic Effects of Derivatives*, available online at <http://www.commodityonline.com/news/Meltdown-The-toxic-effects-of-Derivatives-12759-3-1.html> (Last visited on December 3, 2008).

and are hence void. It may be pointed out here that under Section 30 of the Contract Act, agreements by way of wager have been declared void by reason of being against public policy.

It is a matter of common understanding that most Indian laws have had their roots in English common law; so the next part shall include discuss the English legal framework regarding derivatives, while also exploring the legality of derivative contracts specifically with regards to the Indian Contract Act, 1872. However, the thrust of this chapter will be the recent decision of the Madras High Court in *Rajshree Sugars & Chemicals Limited v. Axis Bank Limited*,³ which shall be analyzed keeping in mind the practices that have often been resorted to by Indian companies. Based on these, we shall seek a conclusion to this paper, wherein we hope to be in a position to suggest reforms keeping in mind the need for financial reform and growth.

II. WHAT ARE DERIVATIVE CONTRACTS?

The term 'derivative' has its origins in the province of mathematics, and pertains to a variable which is derived from, and is dependant on another variable. Since they do not have a value of their own and derive the same from an underlying asset they are termed as derivatives. Derivatives are essentially instruments which derive their values from basic variables termed as 'bases' or from the value of some other asset which termed as the 'underlying asset'. When the underlying is a financial asset like debt instruments, currency, share price index, equity shares, the derivative is known as a 'financial derivative'. These are specialized contracts which constitute an agreement or an option between parties to purchase or sell the underlying asset of the derivate up to a certain time in the future at a prearranged price which is termed as the 'exercise price'. The value of such a contract depends on the expiry period as well as on the price of the underlying asset.⁴

Alan Greenspan, Chairman of the Board of Governors of the United States Federal Reserve System, feels that derivatives help in the differentiation between risks, and allocate it to those capable investors who express their willingness to undertake such risks. This may produce profits in the future, and thereby accelerate national productivity, leading to improved standards of living and overall economic growth.⁵ Although considered to be the surest guarantee for profits, in view of the severe financial crises threatening the world, one is forced to rethink the merits of entering into derivative contracts concerning dealings with foreign exchange on account of fluctuations in the interest rates.⁶ Derivative contracts allow investors to

³ C.S. No. 240 of 2008, Decided on 14.10.2008.

⁴ See generally H. S. HOUTHAKKER & P. J. WILLIAMSON, *THE ECONOMICS OF FINANCIAL MARKETS* 7-9 (1996); ROBERT E. WHALEY, *DERIVATIVES: MARKETS, VALUATION & RISK MANAGEMENT* 11-19 (2007).

⁵ See generally FRED D. ARDITTI, *DERIVATIVES: A COMPREHENSIVE RESOURCE FOR OPTIONS, FUTURES, INTEREST RATE SWAPS AND MORTGAGE SECURITIES* 2-13.

⁶ Susan Thomas, *Derivative Markets for Debt Market Development*, available at <http://www.igidr.ac.in/~susant/PDFDOCS/IFC-debt-derivatives-report.pdf> (Last visited on December 4, 2008).

earn large returns from small movements in the underlying asset's price with the caveat that there could be large losses if the price of the underlying moves against them rapidly. Derivative transactions are entered into for several purposes such as hedging, speculation, arbitrage and others. Such transactions may be standardized and traded on the floor of the stock exchange, in which case they are called 'exchange-traded derivatives'.⁷ Derivative contracts can also be entered into between two independent parties, and the terms of such a contract can be modified in pursuance of the *inter se* negotiations between such parties.⁸

Derivative contracts are classified into—forwards, futures, options, warrants, LEAPS, baskets, swaps and swaptions.⁹ A forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at a pre-arranged price. Such contracts are capable of being modified as per the contract size, date of expiry, and needs of the user. A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a pre-specified price. The futures contracts are a special kind of forward contracts and fall in the standardized category of exchange traded derivatives.¹⁰ Options are further divided into 'calls' and 'puts': the former provides the buyer with the right but not the obligation to purchase at a given price, a given quantity of the underlying asset on or before the agreed future date whereas the latter provides the buyer with the right and not the obligation to sell at a given price, a given quantity of the underlying asset on or before the agreed future date. Longer traded options are termed as warrants and are characterized by 'over-the-counter' trading.¹¹ LEAPS refers to Long-Term Equity Anticipation Securities. These are options having a maturity period extending to three years. Baskets are options on portfolios of underlying assets. The underlying asset is usually a moving average or a basket of assets. Equity index options are an example of basket options. Swaps are portfolios of forward contracts. They are characterized by private agreements between two parties to exchange cash flows in future according to a predefined method. These contracts are of two types – interest rate swaps and currency swaps.¹²

⁷ M.R. Umarji, *Legality of Derivative Transactions* available at http://economictimes.indiatimes.com/Opinion/Todays_Features/Money_Banking/Legality_of_derivative_transactions/articleshow/2917885.cms (Last visited on December 4, 2008); Bergis Desai, *Why Derivative Contracts Could Be Void Anyway?*, available at <http://www.rediff.com/money/2008/mar/29guest2.htm> (Last visited on December 1, 2008).

⁸ JOHN C.HULL, *OPTIONS, FUTURES AND OTHER DERIVATIVES* 1- 8 (Thomas, S. ed.); SUSAN THOMAS, *DERIVATIVES MARKETS IN INDIA* 7-11 (2003).

⁹ *Supra* note 3 per J.V. Ramasubramanian, ¶. 3-9. For a comprehensive understanding of the different types of derivative contracts - Ravi Balasubramanian, *Derivatives & Debt Management*, available at <http://treasury.worldbank.org/web/pdf/balasubramanian.pdf>, (Last visited on December 4, 2008).

¹⁰ ALASTAIR HUDSON, *THE LAW ON FINANCIAL DERIVATIVES* 44, 610 (2006).

¹¹ SEBI Report, available at <http://www.sebi.gov.in/faq/derivativesfaq.html> (Last visited on December 4, 2008).

¹² Rahul Karkun, *Financial with Anuj Thakur et al, Financial Derivatives Market & its Development in India*, available at <http://www.iimcal.ac.in/community/FinClub/dhan/dhan1/art16-idm.pdf> (Last visited on December 3, 2008).

An Interest rate swap agreement is entered into between two parties by which each agree to pay the other on a specified date or dates an amount calculated by reference to the interest which would have accrued over a given period on the same notional principal sum assuming different rates of interest are payable in each case.¹³ In other words, these entail swapping only the interest related cash flows between the parties in the same currency and do not include the principal related cash flows. The currency swaps involve swapping of both the principal and the interest between the parties with the cash flows in one direction being in a different currency than those in the opposite direction.¹⁴ Swaptions include the option to buy or sell a swap that will become operative from the date of the expiry of the options. These are further subdivided into receiver swaptions and payer swaptions. The former is an option to receive in fixed rates and pay in floating rates whereas the latter is an option to receive in floating rates but pay in fixed rates. In other words, a swaption is an option on a forward swap. These are, in simple terms, the different types of derivative contracts.¹⁵

III. THE FINANCIAL DERIVATIVES MARKET: GROWTH IN INDIA

The reasons behind a sudden upsurge of financial derivatives are perhaps attributable to the exponential growth and increasing integration of domestic and international financial markets. Furthermore rapid fluctuations and increasing volatility of asset prices, greater innovations in derivatives markets worldwide and effective implementation of risk management strategies therein have accelerated profit maximization as a result of risk minimization. Improved and economical means of instantaneous communication have also proved to be instrumental in expansion of derivative trade globally.

However with greater proliferation of derivatives based deals, the need to monitor and regulate them have become more pronounced. The Securities Laws (Amendment) Ordinance, 1995, was the executive precursor that laid the foundation for introduction of modern laws relating to trading in derivatives in India. Prior to the submission of the L.C. Gupta Committee Report in March 1998, there was no regulatory framework to govern derivative trading in India, and moreover derivatives *per se* did not fall within the definition of securities. The L.C. Gupta Committee followed by the J.R. Varma Committee Report in June 1998 proposed risk management

¹³ *Hammersmith and Fulham London Borough Council v. Hazell* [1990] 3 ALL ER 33 as cited in NILIMA BHADHHADE, POLLOCK & MULLA ON INDIAN CONTRACT SPECIFIC RELIEF ACTS 923 (2006).

¹⁴ Debashis Dutta Gupta, *Legal and Regulatory Issues in Debt Derivatives*, available at http://www.iief.com/Research/debt_chp12.pdf (Last visited on December 5, 2008).

¹⁵ Nupur Hetamsaria & Vivek Kaul, *All you wanted to know about Derivatives*, available at <http://ia.rediff.com/money/2005/apr/19perfin1.htm>. (Last visited on December 1, 2008).

strategies and monitoring mechanisms for derivative markets.¹⁶ The 1999 Amendment to the Securities Contract Regulation Act, 1956 (*hereinafter* SCRA), widened the ambit of ‘securities’ so as to include ‘derivatives’ and gave the desirable impetus to the development of the derivatives markets in India. Foreign Institutional Investments were allowed to trade in all Exchange traded derivative products. Prohibitions on forward trading in securities were withdrawn by the government in March 2000 and the final authorization was given by SEBI in May 2001 to transact in derivatives. This was followed by relaxation of restrictions on index futures contracts; then trading in options on individual securities; and finally even futures contracts on individual stocks were approved. Thus most restrictions were lifted in a gradual and phased manner thereby unfolding a liberalized derivatives trading regime in India.¹⁷

The legal environment for derivative trading in India today is determined and regulated by SCRA; the Indian Contract Act, 1872 (*hereinafter* Contract Act); Exchange Control Manual (*hereinafter* ECM); Foreign Exchange Management Act (*hereinafter* FEMA), 1999 and Reserve Bank of India Act, 1934 (*hereinafter* RBI Act). With due respect to all abovementioned legislations, an important point that deserves mention in this regard is that none of these legislations were initially introduced or specifically enacted with the intention to control or create a regulatory framework for derivatives trading *per se*. As a result, such legislations have been conveniently used and accordingly interpreted to determine whether derivative transactions are possible and lawful within such a framework.¹⁸

Derivative transactions however, border on falling within the scope of wagering agreements. Section 30 of the Contract Act renders agreements by way of wager void, and this ensures that such contracts are unenforceable in a court of law. In order to surpass the restriction imposed by Section 30, the SCRA has widened the ambit of the term ‘security’ so as to include derivatives also.¹⁹ Section 18A of the SCRA, introduced by way of Amendment in 1999, a provision legalizing derivative contracts provided they are transacted on the floor of a recognized Stock Exchange and in accordance with its respective provisions, rules, byelaws and regulations. However ‘over the counter’ derivative trading continued to be prohibited. The 2006 Amendment to the RBI Act, 1934 redefined the classification

¹⁶ Susan Thomas, *Derivative Markets for Debt Market Development*, available at <http://www.igidr.ac.in/~susant/PDFDOCS/IFC-debt-derivatives-report.pdf> (Last visited on December 4, 2008).

¹⁷ Narender L. Ahuja, *Commodity Derivatives Market in India: Development, Regulation, and Future Prospects*, available at <http://www.eurojournals.com/IRJFE 2 11 Ahuja.pdf> (Last visited on December 4, 2008).

¹⁸ See R.Vaidyanathan, *Derivatives in the Indian Context: Need for Caution*, available at <http://www.iimb.ernet.in/~vaidya/indian-context.pdf> (Last visited on December 4, 2008).

¹⁹ A “derivative” has been defined in The Securities Contracts (Regulation) Act, 1956 (SCRA) in Section 2(ac) “derivative” includes – (A) a security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security; (B) a contract which derives its value from the prices, or index of prices, of underlying securities.

of financial derivatives.²⁰ It empowered the Central Bank to regulate transactions in such derivatives and validates such derivative transactions that have been specified by the Central Bank from time to time. The Amendment was also declared to be retrospective in nature.²¹ This indeed was a very welcome development in the Indian legal regime concerning transactions related to derivative contracts since it expressly clarified the problematic issue of legality of derivatives, and addressed the question whether such derivative contracts could be a agreement of wager or not.

IV. DERIVATIVE CONTRACTS AND THE INDIAN CONTRACT ACT, 1872: ARE THEY ALLOWED?

Indian contract law is indeed woefully deficient with regard to provisions that clarify the legality of derivative contracts. The problematic question whether derivative contracts are in the nature of wagering agreements is not answered by the Act till date and no Amendment to that effect has been passed either. Under Indian exchange control laws, an Indian corporate, being a person resident in India, can enter into a foreign currency derivative contract only to hedge an exposure to foreign exchange risk and not for speculating and yielding profits.²²

Perhaps one of the few cases²³ that directly deal with foreign exchange derivatives and address the abovementioned dilemma is *Rajshree Sugars & Chemicals Limited v Axis Bank Limited*.²⁴ Since March 2008, Axis Bank and Rajshree Sugars have been fighting a legal battle over the foreign exchange derivatives contract, sold by the Bank to the company, thereby resulting in huge losses for the company estimated to be around Rs. 46-50 crores. The company had

²⁰ Section 45U (a) The Reserve Bank of India (Amendment) Bill, 2005 defines “*derivative*” as “.....an instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called “underlying”), or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by the bank from time to time.”

²¹ See The Reserve Bank of India (Amendment) Bill, 2005 Chapter IIID – Regulations of Transactions in Derivatives, Money Market Instruments, Securities etc.

²² M. R. Umarji, *Legality of Derivative Transactions* available at http://economictimes.indiatimes.com / Opinion/Todays_Features/ Money_Banking/Legality_of_derivative_transactions/articleshow/2917885.cms (Last visited on December 4, 2008).

²³ This case, however, is not an isolated one. Numerous companies across the nation have hauled private banks to courts against the derivatives contracts. On suffering losses in such a venture the companies have defended their interests confessing that they never quite entirely understood the dynamics of derivative contracts and the speculative element involved therein and have also further contended that such derivative contracts have contravened RBI guidelines.

²⁴ *Supra* note 3.

refused to make any loan repayment to the bank contending that the contract was a wagering deal, and hence untenable on such grounds. The Madras High Court in October 2008, upheld the validity of derivative contracts thereby recommending the bank to seek the assistance of the Debt Recovery Tribunal in furtherance of loan recovery.²⁵ But on a subsequent hearing against such earlier order, Rajshree Sugars & Chemicals managed to get a stay till November 6, 2008. Granting such stay, the court concluded that the defendant bank was at liberty to work out their remedy in a lawful manner known to law.

The court was faced with two prime issues:

- (i) whether the derivative contract in question was a wagering agreement?, and
- (ii) whether such contract was illegal and opposed to public policy?

The court answered both these issues in the negative.²⁶ When addressing the former question, the court makes certain preliminary observations like the absence of a comprehensive definition of what constitutes a wager in the Indian Contract Act, 1872, even though it elucidates on the consequences of the same. There are references to various English judgments notable among them being that of Justice Hawkins in *Carlill v Carbolic Smoke Ball Company*.²⁷

Justice Hawkins in the landmark judgment delivered in *Carlill v Carbolic Smoke Ball Co.*,²⁸ held that:

“A wagering contract is one by which two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependant on the determination of that event, one shall win from the other, and that other shall pay or hand over to him [her], a sum of money or other stake; neither of the parties having any other interest in that contract than the sum or stake he will so win or lose, there being no other consideration for making of such contract by either of the parties. If either of the parties may win but cannot lose, or may lose but cannot win, it is not a wagering contract.”

²⁵ Such a verdict of the court, asking the bank to approach the Debt Recovery Tribunal, was undoubtedly favourable for the bank and was considered as settling an important precedent for numerous such cases undecided in various parts of the nation as mentioned in “*Rajshree gets High Court Stay in Derivatives Case*” Business Standard, October 21, 2008, available at <http://www.businessstandard.com/india/storypage.php?auto=337883> (Last visited on December 23, 2008).

²⁶ *Supra* note 3 ¶. 53-81, which answers the question of whether a derivative contract is a wager or not and ¶ 82-117 which answer the question whether such derivative contract is illegal and opposed to public policy.

²⁷ [1891-1894] All ER Rep. 127.

²⁸ *Id.*

Furthermore, the court mentions the English Gaming Act of 1845 and elaborates on how it has influenced Section 30 of the Contract Act. Heavily influenced by English decisions, the judges have adopted the essential features of a wagering contract, namely that,

“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. In a wagering contract, 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 contract if one party may win but cannot lose or if he may lose but cannot win or if he can neither win nor lose. The parties have no actual interest in the occurrence or non occurrence of the event, but have an interest only on the stake.”²⁹

Based on these elucidations, the court evolved a threefold test to determine whether the contract is a wager - First, there must be two persons holding opposite views touching a future uncertain event; second, one of those parties is to win and the other is to lose upon the determination of the event; third, both the parties have no actual interest in the occurrence or non-occurrence of the event, but have an interest only on the stake.³⁰ The case in question fulfilled the first criteria, but the second was not satisfied because in the light of the facts of the case, the plaintiff did not always stand to lose. Citing Indian case law,³¹ the judges make an interesting observation, that though every wagering contract is speculative in nature, every speculation need not necessarily be a wager.

Further, a common intention to wager is essential, and an element of mutuality has to be present 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. In the light of abovementioned points and also adhering to the Supreme Court judgment in *Gherulal Parakh v. Mahadeodas Maiya*,³² the Judges in this case concluded that the sequence of events in the present case reflected that the nature of the transaction was not in the form of a wager. Even though the plaintiff was susceptible to incurring huge losses yet that by itself could not deem the contract to be a wager. Moreover there was no common intention between the plaintiff and the bank to enter into a wagering transaction. On the issue of illegality

²⁹ *Supra* note 3 ¶ 55.

³⁰ *Emphasis added.*

³¹ *Bhagwandas Parasram v. Burjori Ruttonji Bomanji*, AIR 1917 PC 101; *Pratapchand Nopaji v. Firm of Kotrike Venkata Setty & Sons and Ors.*, (1975) 2 SCC 208; *Gherulal Parakh v. Mahadeodas Maiya*, AIR 1959 SC 781 as cited in *Rajshree Sugars & Chemicals Limited v. Axis Bank Limited*, C.S. No. 240 of 2008, Decided on 14.10.2008 ¶ 58.

³² AIR 1959 SC 781.

and public policy the court upheld the validity of derivative contracts after elaborating on the historical evolution of the derivatives, highlighting the fact that what is expressly permitted by law, cannot be regarded as opposed to public policy. Furthermore, it also held that the contract in question does not contravene any of the Reserve Bank of India regulations, and such contracts are lawfully permitted under FEMA and have worldwide sanction. The court, after reviewing definitions of derivatives given in important legislations, remarked that the definition of ‘derivative’ in the SCRA is an inclusive definition which preserves its natural meaning.³³ The plaintiff may have incurred heavy losses, but that is not reason enough to declare the contract as void, illegal or opposed to public policy.³⁴

V. AN ANALYSIS OF THE LAW OF WAGERS IN INDIA: THE EFFECT OF SECTION 30

Anson’s Law of Contract defines wager as “a promise to pay money or money’s worth upon the determination or ascertainment of an uncertain event.”³⁵ Section 30 of the Contract Act renders wagering agreements to be void.³⁶ As has been mentioned earlier, it has been adapted from Section 18 of The English Gaming Act, 1845. Section 30 can be read in three parts – first, that it declares a wagering agreement to be void; second, it prevents the winner from recovering any amount won by way of wagering, and lastly it prevents the winner from suing the stakeholder. In other words, the policy of Section 30 is merely to discourage betting.³⁷ The legislative intent behind the Section was only to regulate dealings connected with lotteries, betting, gaming etc., to extend the above provision, so as to include derivative transactions, which was not envisaged by the framers of the legislation.

The Contract Act does not define what constitutes a wager or a wagering agreement. It only mentions that such agreements will be void and unenforceable and no action can lie to either recover anything that is due under a

³³ *Supra* note 3, ¶ 88.

³⁴ *Id.*, ¶ 117.

³⁵ BEATSON, J. ANSON’S LAW OF CONTRACT 337 (1998).

³⁶ Section 30, Contract Act – Agreements by way of wager, void states that,

“Agreements by way of wager are void; and no suit shall be brought for recovering anything alleged to be won on any wager, or entrusted to any person to abide the result of any game or other uncertain event on which any wager is made.”

Exception in favour of certain prizes for horse racing –

“This section shall not be deemed to render unlawful a subscription or any contribution, or agreement to subscribe or contribute, made or entered into for or toward any plate, prize or sum of money, of the value or amount of five hundred rupees or upwards, to be awarded to the winner or winners of any horse race.”

Section 294A of The Indian Penal Code not affected –

“Nothing in this section shall be deemed to legalize any transaction connected with horse racing, to which the provisions of S.294A of The Indian Penal Code (45 of 1860) apply.”

³⁷ NILIMA BHADHBADE, POLLOCK & MULLA ON INDIAN CONTRACT SPECIFIC RELIEF ACTS 906 (2006).

wager or for performance of a contract that is in the nature of a wager. A wager is in the nature of a contingent contract but is prevented from being enforceable by Section 30. However, there is a major difference between the English and the Indian laws relating to wagers: under the English Gaming Act, 1845, agreements collateral to the wagering agreement are also rendered to be void,³⁸ whereas in India, collateral agreements are not necessarily void except in Bombay,³⁹ because the object of such a collateral contract may not necessarily be unlawful. Further the Apex Court held that, "By law an act might be maintained on a wager if it was not against the interest or feelings of a third person, did not lead to indecent evidence and was not contrary to public policy."⁴⁰

As previously mentioned, a number of Indian companies when incurring losses in foreign exchange dealings, construct an argument that derivative transactions are in the nature of wagering agreements, and are hence not enforceable in Indian Courts under Section 30, and hence do not give rise to any liability or financial obligations in respect of repayment of loan to the bank. As a result of this, many conservative Indian banks such as the State Bank of India refrained from entering into any sort of derivative transactions with their clients for a fairly long time.

In the case of wagers, the object of the agreement is not unlawful, if the expression 'object' refers to the actual performance; but if by 'object' is meant the creation of an obligation to perform the things undertaken then such object will be unlawful.⁴¹ This problem has not been dealt with in Contract Act. A contract may be entered into which is lawful in itself, but it may be performed in such a manner or by such means that is in violation of some provision of the law and by doing so, the contracting party deprives itself of any claim to recover on the other party's promise to pay for performance of the contract, whether the other party knew anything beforehand of his unlawful action or not.⁴² The contract entered into by the bank with the company is not *per se* lawful, but it becomes illegal from the point of time when the company cultivates a pre meditated intention to not repay the loan in future if it incurs heavy losses in foreign exchange transactions.

A wagering agreement is characterized by mutual chances of gain or loss and if such a situation does arise whereby one party will only lose and cannot win, then such an agreement will not be a wagering contract. The companies

³⁸ Rajshree Sugars & Chemicals Limited v. Axis Bank Limited, MANU/TN/0893/2008, ¶56.

³⁹ The Act for Avoiding Wagers (Amendment) Act, 1865 (Bombay).

⁴⁰ Gherulal Parakh v Mahadeodas Maiya, AIR 1959 SC 781. (Herein the dispute arose as to whether a partnership formed for the purpose of entering into forward contracts for the purchase and sale of wheat so as to speculate in rise and fall of price of wheat in future, was a wager and whether it was hit by Section 30 of the Contract Act. But the Supreme Court held that such a partnership was not illegal, although the business, for which the partnership was formed, was held to involve wagering).

⁴¹ BHADBHADE, *supra* note 37, 643.

⁴² *Id.* 642.

contention that such a contract being a wagering agreement is void, cannot be maintainable when the Company already has an intention of not paying the loan in the event of its facing losses in foreign exchange transactions in the future since in such a case the bank will be a contracting party who will always lose and never have any chance of winning. When providing a company with finance, the bank's primary motive is recovery of the loan advanced, whereas earning of any interest thereon is merely an additional motive. Furthermore, when the companies contend that the contract that they have entered into with the bank is a wagering agreement, the wager can at best pertain to the additional interest that would be generated out of the speculative venture. This interest is to be clearly differentiated from the principal amount which was invested in the speculative venture. Thus, in the event of failure of the speculative venture and resultant non performance of the contract, the financial obligation of the corporate to repay the principal amount, taken as loan and invested in the speculative venture is not eroded in any way. Moreover in order to constitute a wagering agreement, a common intention to wager is essential. But in the given situation, the bank is an innocent party to the contract who is unaware of the fact that the company may default to repay and at a later date, contend that the impugned contract is a wagering agreement and hence void under Section 30. But given the fact that the banks are adversely affected by such a convenient move on the part of the company, such an act could be deemed to be contrary to public policy and the Contract Act is in essence furthering such an unlawful activity.

VI. PUBLIC POLICY: THE IMPLICATIONS OF SECTION 23

An analysis of Section 23 of Contract Act⁴³ reveals that upholding the legality of contracts is the usual presumption of law. However, in some cases the law may refuse to effectuate a transaction on the ground of illegality, thus proving to be a limitation on the freedom of contract. Such illegality may arise as a result of the contract itself being prohibited by law, or because of the unlawful nature of its consideration or object, or in situations where the courts of law consider the enforcement of contract immoral or contravening public policy. Furthermore, the effect of illegality on the contract also differs with cases as sometimes the courts may refuse enforcement of the contract altogether, whereas in other situations the courts may apply the doctrine of severability, or perhaps provide redressal to the aggrieved party who is the innocent victim of the illegality. When judging the

⁴³ Section 23, Contract Act states that,

“What considerations and objects are lawful, and what not— the consideration or object of an agreement is lawful, unless –

it is forbidden by law; or

is of such a nature that, if permitted, it would defeat the provisions of any law; or

is fraudulent; or

involves or implies injury to the person or property of another; or

the court regards it as being immoral, or opposed to public policy.

In each of these cases, the consideration or object of an agreement is said to be unlawful.

Every agreement of which the object or consideration is unlawful is void.”

extent of illegality of the contract, the court considers whether there has been illegality and whether such illegality outrages public morality or public conscience. It has been held that where the contract is such that it affects not only the parties to it; but if permitted and recognized, it would have deep repercussions adversely affecting the public at large, it would be unlawful under Section 23.⁴⁴

It is admitted that when there is increased market penetration it is normal that a financial institution may run the risk of failing to look into all the balances that need to be maintained before advancing loans to companies or individuals. The banks chased a chimera called credit derivatives when entering into such contracts with the companies, and in the event of non payment were indeed adversely affected. Although unfortunate, nay catastrophic, it is our opinion that it is still not something legally improper.—It is possible that in the aftermath of heavy losses, banks will now be reluctant to lend, thereby reducing investment and production in the economy which in turn will promote inflationary tendencies.⁴⁵ These factors coming together promise to be disastrous for the economy, and the cycle that would have the insecurity of the banks as the starting point, may bring the entire economy to a grinding halt. However, all said and done, it still does not provide the law with an excuse to regulate the financial situation by interpreting a law in a way in which it was never supposed to be interpreted.

VII. CONCLUSION

The most noteworthy point with regard to the foreign exchange derivative crisis faced by both the banks and companies was that neither the selling banks nor the purchasing companies were entirely and clearly able to identify what such a contract or such a transaction would ultimately lead to. As a result, numerous petitions were filed that the companies had deluded the banks.⁴⁶ Although we are not yet in a position to make an authoritative assertion on the question of the propriety of allowing such legal proceedings, it is clear that stringent regulation and rigid supervision is indeed the need of the hour.

In the aftermath of such severe financial wreckage worldwide, it is but obvious that global money markets will not be the same anymore. Even the US, which is popularly thought of to be the land of unbridled private enterprise, are working towards allowing more stringent regulatory oversight over the financial markets. Even outside the US., this has generally been the trend across the world. As has been discussed earlier, India is not insulated from global financial markets,

⁴⁴ Naveen Chandra Sharma v. Sixth Addl. District and Sessions Judge, Meerut, AIR 1983 All 116.

⁴⁵ A. V. Rajwade, *Why Derivatives are Weapons of Mass Destruction?*, available at <http://www.rediff.com/money/2008/nov/18why-derivatives-are-dangerous.htm> (Last visited on December 5, 2008); Monty Guild, Tony Danaher, *Meltdown: The Toxic Effects of Derivatives*, available at <http://www.commodityonline.com/news/Meltdown-The-toxic-effects-of-Derivatives-12759-3-1.html> (Last visited on December 5, 2008).

⁴⁶ S.K. Ramanathan, *Approach arbitrator, court tells Sundaram Brake*, BUSINESS STANDARD (Chennai), August 19, 2008.

and is already facing the brunt of the global meltdown. An increasing exposure to derivative instruments without proper regulatory overseeing, together with a rapid withdrawal of foreign institutional investment in the face of such a severe financial meltdown, adversely affected Indian money markets. In the event of non recovery of loans advanced by the banks in the form of stocks, bonds and derivatives, almost the entire financial market collapsed because these instruments were integrated and closely connected in most operations.

Thus certain reformatory measures need to be initiated and gradually implemented, –which in our opinion may be of the following nature:

- i. First, even though The RBI (Amendment) Act, 2006 carves out an exception to the provisions of the Contract Act, an Amendment to Section 30 of Contract Act creating specific exceptions to wagering contracts and thereby validating them, should be immediately enacted. This would serve the purpose of clearing the law further.
- ii. Second, the Contract Act should provide an express definition that would clarify as to what constitutes a wager, thereby removing any ambiguity with regard to legality of derivative contracts which are in the nature of wagering agreements.
- iii. Third, when creating regulatory measures addressing legal validity of derivative contracts, discrepancies in relation to jurisdictional aspects in derivative transactions should be carefully considered and accordingly removed.

Further, the requirement of capital adequacy should be made mandatory for all financial institutions and every financial product on offer should be subject to monitoring and regulation. The detailed financial packages offered by the investment banks to the large corporations, and other documentation involved therein should be opened up for scrutiny. Since there is no established exclusive regulatory authority for Indian Rupee derivatives, a loophole is created whereby contracting parties may decide to contract on the basis of legally untenable documentation which will not fall under the control or regulation of either the RBI, SEBI, or the Ministry of Finance.

Thus, changes should be incorporated in both the SCRA, as well as the Contract Act, to enable and administer domestic debt derivatives, by a collective effort of the three aforementioned institutions. It would indeed be naive to assume that any individual nation can successfully regulate global financial markets in isolation. Thus, what constitutes an utmost necessity, in the light of the recent financial market experiences, is the creation of a regulatory framework by virtue of which disparities between financial flows and trade flows will be gradually smoothed. However, this framework has to be in consonance with internationally prescribed standards, and hopefully even leading to an international protocol.