



The concept of debentures: A doctrinal analysis

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Abstract

Corporate Law deals with the formation and operations of corporations and is related to commercial and contract law. A corporation is a legal entity created under the laws of the state it's incorporated within. Debt finance is a mode of raising assets of the corporation to fund the capital assets as well as day to day activities. The research paper discusses the meaning of debt financing and debentures. It also analyses the concept of debenture stock. The research distinguishes between shareholder and debenture holder. It examines the process of issuance of debentures and types of debentures. The paper discusses the provision of the Company Act, 2013 with regards to rights of debenture holder. It concludes by making a comment on the present legal scenario with regards to debt financing and debentures.

Keywords: debt finance, debenture, debenture stock, debenture holder, issue of debenture

Introduction

Debt Finance- The Conceptual Understanding

The term 'debt' implies the sum of sum of money that ought to be paid back and the term 'financing' refers to the process of supplying funds that are required to run business activities. Therefore, the term 'debt finance' refers to the time bound process of borrowing money by a company which is paid back to the lender at the end of agreed tenure along with interest.

The repayments could be made on a monthly bases, or on half yearly bases, or towards the termination of the loan period. The major reason for a firm to take loan is to finance either a working capital or an acquisition. When companies are in requirement of a humongous loan, the owner of that company attaches a few assets of the firm and then those assets are evaluated to provide loan.

The source of such financing could stem either from a secured or unsecured loan. When the source of debt springs from secured loan, then such loan is safeguarded by putting a collateral over the assets of borrowing company. Whereas, in case of unsecured loans, the debt is although not safeguarded but the line of credit is generally less.

The procedure of debt financing is a costly procedure of procuring funds as the borrowing firm is required to involve an investment banker to facilitate the systematic structure of big loans. The recourse is resourceful when costs are meagre and returns are better. The most imperative feature of the contrivance of debt financing is that the ownership in the company is not lost by the owners. A company decides to undergo debt financing because they do not have to invest their own capital. However, it is pertinent to note that gargantuan debt is also hazardous therefore the companies opt to decide a comfortable level of debt to equity ratio.

Categorisation of Debt Financing on the bases of duration

Debt finance could either occur from channel of long term finance or from long term finance. Long term debt financing is generally applicable to assets that a business plans upon purchasing capital assets like land, buildings, equipment or machinery. The scheduled repayment of borrowed loan and

the estimation of useful span of the assets extend beyond the period of one year. A lender will in general parlance be required to purchase the assets in order to secure long-term loans ^[1].

On the other hand, short term debt finance is applicable to provide for assets that are needed for funding day to day business operations such as payment of wages to the employees, purchase of inventory or supplies. The repayment of such financing occurs in a span of less than one year, therefore such financing is also termed as operating loan or short-term loan.

Advantages and Disadvantages of Debt Financing

Debt financing as a channel of raising capital has many advantages.

Firstly, the ownership does not get diluted as the borrowing corporation does not have to give out a stake in their company.

Secondly, the present management retains full management and control. Fundamentally, all equity investors tend to leverage some degree of authority in the decision making procedure of companies they in whereas a lender has no authority to interfere in the management affairs of the company.

Thirdly, it aids in enhancing the creditworthiness of the business. Incidentally, the credit of business offers also increases.

Fourthly, it also proves to be instrumental in covering up future cash scarcity in an effective manner.

Fifthly, the payments of Interest are tax deductible. Any interest that is paid on money that is borrowed for business activities is tax deductible.

Sixthly, taxes decrease the interest rate. Due to the tax advantages of debt financing, one will need to adjust their interest rate when comparing debt financing to alternative financing options.

The point can be illustrated by a hypothetical example, imagine that a person was evaluating whether or not to take a loan with an interest rate of 15%. Assuming that his business tax rate was 24%, his after- tax interest rate is

10.5% (15% – (1 – 24%). When bringing taxes come into the picture, 10.5% would be the actual interest rate that one would need to use in forecasts about his business. This is one of those times in which taxes can actually help one improve his bottom line.

Lastly, the method of debt financing is accessible to any size of businesses. Though there are various alternative methodologies of raising funds but many of them are not accessible to small business owners. The following two examples speak of the advantages of debt financing.

First, according to data from the U.S. Small Business Administration (SBA) in 2012, only 2% of small businesses listed venture capital as a source of funding. On the other hand, 87% of small businesses listed debt financing as a source of funding. One key reason is that venture capitalists are looking for the next “unicorn” (companies with an estimated valuation north of \$1 billion) and that disqualifies a majority of small businesses, even those with a positive cash flow history.

Second, while sole proprietorships are not barred from issuing bonds, very few can comply with the mandatory federal regulations and cover the associated expenses with the process of issuing bonds. If a person thinks meeting the necessary requirements for an asset-based collateral loan can be hard, then complying with the more stringent collateral requirements for issuing bonds is virtually impossible. On the other hand, even the smallest of small business can shop around for some form of debt financing.

Debt financing however, is not unscathed either. *Firstly*, one of the major drawback of the procedure is that there lies a possibility of conflict. All the partners would not at all times tend to concur in decision making process. The conflict for opinion may erupt from different ideologies for the business and would have dissenting opinions on model of management.

Secondly, Equity investors expect to receive a return on their money. The business owner must be willing to share some of the company's profit with his equity partners. The amount of money paid to the partners could be higher than the interest rates on debt financing.

Thirdly, the owner has to give up some control of his company when he takes on additional investors. Equity partners want to have a voice in making the decisions of the business, especially the big decisions.

Debenture

Meaning

The word 'debenture' has been derived from a Latin word 'debere' which literally means to borrow. Debenture principally stands for a written instrument of corporate debt that acknowledges money that is lent and repayment that is guaranteed with interest and creation of security on the assets of company in lieu of due performance of its obligation. The instrument comprises of a contract stipulating repayment of principal amount at fixed rate of interest after the culmination of prior specified period or at intermissions or if the company so opts for

It is one of the methodologies of arranging for the loan capital of the business. In simple terms, a debenture is thus like a certificate of borrowing or a loan bond proving the fact that the Company is liable to pay a postulated amount with interest. At this juncture, it needs to be mentioned that though the capital structure of the company is enhanced by money raised by mode of debenture, it does not formulate

part of share capital of the firm. Hence, It is one of the methods of raising the capital by the company. In simple words it can be denoted as "Debt or loan".

The term incorporates “debenture stocks, bonds and any other securities of a company, whether constituting a charge on the assets of a company or not” as defined in the Companies Act ^[2]. The definition is an inclusive one and amounts to borrowing of monies from the holders of debentures on such terms and conditions subject to which the debentures have been issued.

Characteristics of Debentures

The characteristic features of a debenture can be enumerated are as follows:

1. It is a movable property.
2. It is issued by the borrowing company and is in the form of a certificate of indebtedness.
3. It generally specifies the date of redemption. It also mentions the repayment of principal amount and interest at specified date or dates as agreed upon.
4. It generally creates a charge on the undertaking or undertakings of the company

The terms and conditions of debentures usually contain the words '*pari passu*'. The term denotes that all the debenture holders belonging to a particular class will receive the money proportionately in scenario where the company is unable to discharge its due obligation. In cases where the terminology is absent in terms and conditions, the debenture-holders would be ranked in accordance with the rank of the date of issue and if the debentures are issued on the same date then priority would be given in the order of time when they were issued, which is also known by the serial number of the debenture.

Debenture Stock

The company at certain instances, instead of issuing individual debentures that provide proof of separate and distinct debts, may create one collective loan fund known as 'debenture-stock.' The stock is divisible among a class of lenders each of whom is provided with a debenture-stock certificate which provides evidence of the parts of the whole loan to which the stock holder is entitled. The fine distinction leads to the implication that while whereas a debenture is a single instrument which can be legally transferred as one entity only, debenture-stock can be subdivided and transferred in any smaller fractions which the holder wishes. Another differentiation that makes a distinction between debenture and debenture stock is that while 'debenture-stock' must be fully paid, debenture may or may not be fully paid. However, for the purposes of the Companies Act, 'debenture' includes 'debenture stock' within its ambit ^[3].

Distinction between Shareholder and Debenture holder

This section attempts to differentiate between 'shareholder' and 'debenture holder'. These differences are enumerated as follows:

- A shareholder is a member of the company whereas a debenture holder is a lender to the company.
- A shareholder has a right to vote. A debenture holder does not enjoy such a right. no company shall issue any debentures carrying voting rights ^[4]. "Voting right" means the right of a member of a company to vote in

any meeting of the company or by means of postal ballot.

- Income on shares depends on the profits. Shareholders are entitled to get dividend only out of profits. Debenture holders are entitled to a fixed rate of interest which the company must pay irrespective of profits, i.e., profits or no profits.
- In the event of winding-up, shareholders cannot claim payment unless all outside creditors have been paid in full. Debenture holders, normally being secured lenders, have prior claim for repayment.
- Dividend on shares is not a charge against profit. Interest on debentures, on the other hand, is a charge against the profits and is deducted from revenues for the purpose of calculating tax liability.

Issue of Debentures

Debentures are commonly issued in a similar manner as shares by means of a prospectus inviting applications, the money being usually payable by instalments on application, allotment and on specified dates. It is provided that the debenture certificate must be issued to the allottee within a period of shall months from the date of allotment^[5]. In case of default, the company is punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with fine which shall not be less than twenty five thousand rupees but which may extend to one lakh rupees^[6].

Apart from these, section 71 of the Companies Act, 2013 contains the following provisions with respect to issue of debentures:

1. A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption provided the same is approved by a special resolution passed at a general meeting.
2. A company is entitled to issue any debentures that any voting rights.
3. A company may issue secured debentures. Such debentures shall be subject to such terms and conditions as prescribed by the Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014. Rule 18^[7] prescribes that:
 - a. The date of redemption shall not exceed ten years from the date of issue of debenture except for certain prescribed cases where redemption may be up to 30 years;
 - b. The issue of debenture shall be secured by the creation of a charge;
 - c. The company is obligated to appoint a debenture trustee before the issue of prospectus or letter of offer for subscription of its debentures and not later than sixty days after the allotment of the debentures, execute a debenture trust deed to protect the interest of the debenture holders; and
 - d. The security for the debentures by way of a charge or mortgage shall be created in favour of the debenture trustee.
4. Where debentures are issued by a company under this section, the company shall create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account shall not be utilised by

the company except for the redemption of debentures.

5. No company shall issue a prospectus or make an offer or invitation to the public or to its members exceeding five hundred for the subscription of its debentures, unless the company has, before such issue or offer, appointed one or more debenture trustees.
6. A debenture trustee shall take steps to protect the interests of the debenture-holders and redress their grievances in accordance with the prescribed rules.
7. Any provision contained in a trust deed for securing the issue of debentures, or in any contract with the debenture-holders secured by a trust deed, shall be void insofar as it would have the effect of debentures, or in any contract exempting a trustee thereof from, or indemnifying him again, liability for breach of trust, where he fails to show the degree against liability and due diligence required of him as a trustee, having regard to provisions of the trust deed conferring on him any power, authority or discretion. However, the liability of the debenture trustee shall be subject to such exemptions as may be agreed upon by a majority of debenture-holders holding not less than three-fourths in value of the total debentures at a meeting held for the purpose.
8. A company shall pay interest and redeem the debentures in accordance with the terms and conditions of their issue.
9. Where at any time the debenture trustee comes to a conclusion that the assets of the company are insufficient or are likely to become insufficient to discharge the principal amount as and when it becomes due, the debenture trustee may file a petition before the Tribunal and the Tribunal may, after hearing the company and any other person interested in the matter, by order, impose such restrictions on the incurring of any further liabilities by the company as the Tribunal may consider necessary in the interests of the debenture-holders.
10. Where a company fails to redeem the debentures on the date of their maturity or fails to pay interest on the debentures when it is due, the Tribunal may, on the application of any or all of the debenture-holders, or debenture trustee and, after hearing the parties concerned, direct, by order, the company to redeem the debentures forthwith on payment of principal and interest due thereon.
11. If any default is made in complying with the order of the Tribunal under this section, every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than two lakh rupees but which may extend to five lakh rupees, or with both.
12. A contract with the company to take up and pay for any debentures of the company may be enforced by a decree for specific performance.
13. The Central Government may prescribe the procedure, for securing the issue of debentures, the form of debenture trust deed, the procedure for the debenture-holders to inspect the trust deed and to obtain copies thereof, quantum of debenture redemption reserve required to be created and such other matters.

Kinds of Debentures

Debentures may be of the following kinds:

Bearer debentures: Bearer debentures are similar to share warrants in that they too are negotiable instruments, transferable by delivery. The interest on 'bearer debentures' is paid by means of attached coupons. On maturity, the principal sum is paid to the bearers.

Registered debentures: These are debentures which are payable to the registered holders, i.e., persons whose names tend to appear in the Register of debenture. Such debentures are transferable in same way as shares or in accordance with the conditions endorsed on their back.

The debenture itself consists of two parts:

- a. The covenants by the company to pay the principal and interest, and
- b. The endorsed conditions, e.g., the term of the loan. The endorsed conditions vary, but they normally contain a provision that the debenture is one of a series all ranking *pari passu*. Where debentures rank *pari passu*, they will be discharged in proportion to the amount due in respect both of capital and interest, i.e., in the event of a deficiency of assets, if the interest on some debentures is paid down to a later date than others, the interest due on each is added to the capital thereof, and a proportionate distribution of the assets made. If there were no such provision, the debentures would rank in the order of issue regarding the assets charged by the company.

Perpetual or irredeemable debentures: A debenture which contains no clause as to payment or which contains a clause that it shall not be paid back is called a perpetual or irredeemable debenture. Though irredeemable debentures were allowed under section 120 of the Companies Act, 1956, no corresponding provision has been made under the Act of 2013. Thus, no fresh irredeemable debentures may be issued by the companies.

Redeemable debentures: Redeemable debentures are to be redeemed as per the terms of the issue. Section 71 and the rules framed there under regulate issue of such debentures and the same have been discussed in the aforesaid paragraphs.

Naked debentures: Normally, debentures are secured by a mortgage or a charge on the company's assets. However, debentures may be issued without any charge on the assets of the company. Such debentures are called 'Naked or unsecured debentures'. They are mere acknowledgements of a debt due from the company, creating no rights beyond those of ordinary unsecured creditors. Unsecured debentures are treated as deposits and should, therefore, conform to requirements applicable to public deposits accepted by a company.

Convertible debentures: A company may also issue convertible debentures, in which case an option is given to the debenture-holders to convert them into equity or preference shares at stated rates of exchange, after a certain period. Section 71 requires the company to pass a special resolution for issue of convertible debentures whether wholly or partly. Such debentures once converted into shares cannot be reconverted into debentures.

According to convertibility, debentures are further classified into three categories:

Fully Convertible Debentures (FCDs): Those debentures that are converted into equity shares of the company on the

expiry of specified period or periods.

Non-Convertible Debentures (NCDs) - those debentures that do not confer any option on the holder to convert the debentures into equity shares and are redeemed at the expiry of a specified period(s).

Partly Convertible Debentures (PCDs) - debenture consists of two parts, *viz.*, convertible and non-convertible. The convertible portion(s) is/are convertible into equity shares at the expiry of specified period(s). Non-convertible portion, on the other hand, is redeemed at the expiry of a certain period(s).

Debenture Trust Deed

When debentures are issued for public subscription, involving a considerable number of debenture-holders, it is not feasible to create a separate charge in favour of thousands of debenture-holders. Therefore, the most common and convenient form of securing them is to execute a Trust Deed conveying the property of the company to the trustees and declaring a trust in favour of the debenture-holders. A trust deed normally grants the trustees a fixed charge over the company's freeholds and leaseholds and a floating charge over the rest of the property. The trust deed contains the terms and conditions endorsed on the debentures and defines the rights of the debenture-holders and the company. A trust deed normally contains clauses giving the trustees the following powers, *inter alia*:

1. To take a mortgage over the company's property in which case the title deeds are transferred to them and the company is thereafter prevented from creating further charges ranking in priority to debentures;
2. To sell or lease the property and to renew leases;
3. To exchange the mortgaged property for other suitable property;
4. To modify subsisting contracts applying to any Part of the property;
5. To compromise claims;
6. To commence and defend actions; and
7. To appoint a receiver on the security becoming enforceable.

The advantage of trust deed is that it becomes the function of the trustees to watch the interest of the debenture-holders who are bound to act honestly and with due care and diligence. In fact, any clause in the trust deed exempting them from liability for breach of their duty as trustees or which indemnifies them against liability is void. The trustees have a legal mortgage over the company's property, so that persons who subsequently lend money to the company cannot gain priority over the debenture-holders. If and when, the company makes a default, the trustees can take action for enforcing the security on behalf of the debenture-holders. The trustees can ensure that the property is kept insured and properly maintained. It would not be practicable for a large and fluctuating body of debenture-holders to do this.

The Companies Act, 2013 vide Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014^[8] contains the following provisions in this regard:

Appointment of Debenture Trustee: The Company shall appoint a debenture trustee before the issue of prospectus or letter of offer for subscription of its debentures and not later than sixty days after the allotment of the debentures, execute

a debenture trust deed in Form No. SH.12 or as near thereto as possible to protect the interest of the debenture holders.

Creation of Security: The security for the debentures by way of a charge or mortgage shall be created in favour of the debenture trustee on:

1. Any specific movable property of the company (not being in the nature of pledge); or
2. Any specific immovable property wherever situate, or any interest therein.

Consent of Debenture Trustee: The names of the debenture trustees shall be stated in letter of offer inviting subscription for debentures and also in all the subsequent notices or other communications sent to the debenture holders;

Before the appointment of debenture trustee or trustees, a written consent shall be obtained from such debenture trustee or trustees proposed to be appointed and a statement to that effect shall appear in the letter of offer issued for inviting the subscription of the debentures;

Disqualifications of Debenture Trustee: A person shall not be appointed as a debenture trustee, if he:

1. beneficially holds shares in the company;
2. is a promoter, director or key managerial personnel or any other officer or an employee of the company or its holding, subsidiary or associate company
3. is beneficially entitled to moneys which are to be paid by the company otherwise than as remuneration Payable to the debenture trustee;
4. is indebted to the company, or its subsidiary or its holding or associate company or a subsidiary of such holding company;
5. has any pecuniary relationship with the company during the two immediately preceding during the current financial year;
6. is relative of any promoter or any person who is in the employment of the company as a director or key managerial personnel.

Casual Vacancy in the office of Debenture Trustee: The Board may fill any casual vacancy in the office of the trustee but while any such vacancy continues, the remaining trustee or trustees, if any. However, where such vacancy is caused by the resignation of the debenture trustee, the vacancy shall only be filled with the written consent of the majority of the debenture holders.

Removal of Debenture Trustee: Any debenture trustee may be removed from office before the expiry of his term only if it is approved by the holders of not less than three fourth in value of the debentures outstanding, at their meeting.

Duties of Debenture Trustee: It shall be the duty of every debenture trustee to:

- a. Satisfy himself that the letter of offer does not contain any matter which is inconsistent with the terms of the issue of debentures or with the trust deed;
- b. satisfy himself that the covenants in the trust deed are not prejudicial to the interest of the debenture holders;
- c. call for periodical status or performance reports from the company;
- d. communicate promptly to the debenture holders defaults, if any, with regard to payment of interest or redemption of debentures and action taken by the

trustee therefor,

- e. appoint a nominee director on the Board of the company in the event of
- f. two consecutive defaults in payment of interest to the debenture holders; or
- g. Default in creation of security for debentures; or
- h. Default in redemption of debentures.
- i. ensure that the company does not commit any breach of the terms of issue of debentures or covenants of the trust deed and take such reasonable steps as may be necessary to remedy any such breach; inform the debenture holders immediately of any breach of the terms of issue of debentures or covenants of the trust deed;
- j. ensure the implementation of the conditions regarding creation of security for the debentures, if any, and debenture redemption reserve;
- k. ensure that the assets of the company issuing debentures and of the guarantors, if any, are sufficient to discharge the interest and principal amount at all times and that such assets are free from any other encumbrances except those which are specifically agreed to by the debenture holders;
- l. do such acts as are necessary in the event the security becomes enforceable;
- m. call for reports on the utilization of funds raised by the issue of debentures;
- n. take steps to convene a meeting of the holders of debentures as and when such meeting is required to be held;
- o. ensure that the debentures have been converted or redeemed in accordance with the terms of the issue of debentures;
- p. Perform such acts as are necessary for the protection of the interest of the debenture holders and do all other acts as are necessary in order to resolve the grievances of the debenture holders.

Meeting of Debenture-holders: The meeting of all the debenture-holders shall be convened by the debenture trustee on-

- a. Requisition in writing signed by debenture holders holding at least one-tenth in value of the debentures for the time being outstanding;
- b. The happening of any event, which constitutes a breach, default or which in the opinion of the debenture trustees affects the interest of the debenture holders.

Rights of Debenture-Holders

As per Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014, the Debenture Trustee shall communicate promptly to the debenture-holders defaults, if any, with regard to payment of interest or redemption of debentures and action taken by the trustee therefor. Besides, he will appoint a nominee director on the Board of the company in the event of two consecutive defaults in payment of interest to the debenture holders or default in redemption of debentures^[9].

It is pertinent to mention that Section 71 provides that where a company fails to redeem the debentures on the date of their maturity or fails to pay interest on the debentures when it is due, the Tribunal may, on the application of any or all the debenture-holders, or debenture trustee and, after hearing the parties direct, by order, the company to redeem

the debentures forthwith on payment of principal and interest due thereon ^[10] any default is made in complying with the order of the Tribunal under this section, every officer of the company who is in default shall be punishable fine and imprisonment for a term which may extend to three years or with fine which shall not be less than two lakh rupees but which may extend to five lakh rupees, or with both ^[11].

Conclusion

A company many a times is in need to borrow funds from various sources. In case of debt financing, though the ownership is not diluted but the liability is created. Therefore, a company needs to balance its both the sources of financing. It should balance between the equity and debt financing. Generally, the debt-equity ratio says a lot about the financial conditions and capabilities of the company.

Bonds are also a type of debt financing. They create a liability in the company's balance-sheet. They are issued not only by the businesses but also by the governments. The Companies Act treats bonds at par with the debentures. As per sec. 2(30) debentures includes bonds. They are regulated under The Companies (share capital and debentures) Rules, 2014. These regulations work along with the regulations that are imposed by the all-powerful market regulator the Securities and exchange Board of India (SEBI).

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