All about Debentures:
An Appraisal

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INTRODUCTION
Debenture includes debenture stock, 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. This is an inclusive definition and amounts to borrowing of monies from the holders of debentures on such terms and conditions subject to which the debentures have been issued. Basically it is a document or certificate signed by the authorized officers of a company acknowledging money lent and guaranteeing repayment with interest and creating security on the assets of the company for due performance of its obligation. This is a debt instrument and is the commonest method of raising loan capital, as part of project financing. Debentures may be redeemable as envisaged in the Companies Act or mandatorily convertible wholly into the equity shares of a company as envisaged under FEMA. While the articles of a company should contain an enabling provision for issue of debentures and creation of security therefor by the Board, the quantum of such issue should be adequately covered by a borrowing resolution of its shareholders under section 293(l)(d) of the Companies Act, 1956 (the Act).

ISSUE OF DEBENTURES AND CREATION OF SECURITY
A company which issues debentures is under an obligation to create security therefor pursuant to section 117A of the Act by executing trust deed. The need for executing a trust deed will arise when a company wants to issue a prospectus or letter of offer to the public for securing subscription to its debentures and for this purpose should appoint one or more debenture trustees. The above documents should state that the debenture trustees have consented to be appointed as such as required by section 117B of the Act. Thus a debenture trustee enjoys a unique position of being an independent entity unconnected with the issuer of security but appointed to protect the interest of holders of debentures.

QUALIFICATION FOR APPOINTMENT OF DEBENTURE TRUSTEE
All and sundry cannot be appointed as trustees. A person holding shares beneficially in the issuer company or beneficially entitled to receive moneys from that company and has provided any guarantee in respect of principal debts secured by the debentures or interest thereon cannot be appointed as a trustee, as specified in the Act. SEBI (Debenture Trustee) Regulations, 1993 additionally provide that no entity shall be entitled to act as debenture trustee unless at is either a scheduled bank carrying on commercial activity or a public financial institution within the meaning of section 4A of the Act or an insurance company, or a body corporate. It is also necessary that such an entity should have capital adequacy of net worth of one crore of rupees and have been licensed by SEBI to act as a debenture trustee.

FUNCTIONAL ROLE OF DEBENTURE TRUSTEE
The Debenture Trustee is an intermediary between the issuer of debentures and the holders of debentures. Accordingly the main responsibility of debenture trustee is to protect the interest

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of holders of debentures including creation of security by the company issuing the debentures and to redress their grievances.

(i) Companies Act
Under the Companies Act, 1956 the debenture trustee has the following responsibilities:

(a) To ensure that the assets of the company issuing debentures and each of the guarantors are sufficient to discharge the principal amount at all times.
(b) To satisfy that the prospectus or the letter of offer does not contain any matter which is inconsistent with the terms of debentures or with the trust deed.
(c) To ensure that the company does not commit any breach of covenants and provisions of the trust deed.
(d) To take such reasonable steps to remedy any breach of the covenants of the trust deed or the terms of issue of the debentures.
(e) To take steps to call a meeting of holders of debentures as and when such meeting is required to be held.

Needless to say that the aforesaid responsibilities envisaged in Section 117B(3) of the Act are intended to protect the interest of the debenture holders. One of the aforesaid requirements relate to adequacy of security so that in the event of failure of issuer of security to redeem the debentures,(which is an event of default) the Debenture Trustee should enforce the security and pay off the debenture holders by disposing off the secured assets.

SEBI Regulations
Regulation 15 of SEBI (Debenture Trustees) Regulations, 1993 prescribes the following duties of the Debenture Trustee:

(a) To call for periodical reports from the body corporate, i.e., issuer of debentures.
(b) To take possession of trust property in accordance with the provisions of the trust deed.
(c) To enforce security in the interest of the debenture holders.
(d) To ensure on a continuous basis that the property charged to the debenture is available and adequate at all times to discharge the interest and principal amount payable in respect of the debentures and that such property is free from any other encumbrances save and except those which are specifically agreed with the debenture trustee.
(e) To exercise due diligence to ensure compliance by the body corporate with the provisions of the Companies Act, the listing agreement of the stock exchange or the trust deed.
(f) To take appropriate measures for protecting the interest of the debenture holders as soon as any breach of the trust deed or law comes to his notice.
(g) To ascertain that the debentures have been converted or redeemed in accordance with the provisions and conditions under which they are offered to the debenture holders.
(h) Inform the Board immediately of any breach of trust deed or provision of any law.
(i) Appoint a nominee director on the board of the body corporate in the event of:
   (i) two consecutive defaults in payment of interest to the debenture holders; or
   (ii) default in creation of security for debentures, or
   (iii) default in redemption of debentures.
(j) No debenture trustee shall relinquish its assignments as debenture trustee in respect of the debenture issue of any body corporate, unless and until another debenture trustee is appointed in its place by the body corporate.

Rule 17A of the aforesaid Regulation provides that every debenture trustee should appoint a compliance officer and he shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, etc., issued by the Board or the Central Government for redressal of investor’s grievances.

Thus a Debenture Trustee occupies a pivotal position of trust and confidence between the company which issues debentures and the debenture holders who subscribe for the debentures.

CONTENTS OF THE DEBENTURE TRUSTEE AGREEMENT
Schedule IV to SEBI Regulations lists some of the clauses which are to be included in the Debenture Trustee Agreement. They are:

(a) Preamble,
(b) Description of the Instrument,
(c) Details of charged securities
   (i) nature of charge,
   (ii) examination of title,
   (iii) rank of the charge, i.e., whether first, second, or pari passu charge, etc.
   (iv) charging of future assets,
   (v) time limit for creation of charge,
   (vi) minimum security cover required,
   (vii) valuation of security,
   (viii) circumstances in which security becomes enforceable,
   (ix) method and preservation of secured property etc.
(d) Events of default.
(e) Rights of Debenture Trustee.
(f) Obligations of the body corporate (i.e., Issuer of debentures).

Apart from the above, the Agreement will have to include the following provisions:

(i) Definition and Interpretation,
(ii) Appointment of Debenture trustee and its powers,
The broad guidelines are as follows.

- **Remuneration of Debenture Trustee,**
- **Appointment of debenture Trustee as Attorney,**
- **Negative pledge ie not to create additional encumbrances on the secured asset,**
- **Description of Events of Default, which may arise due to Non-payment to debenture holders, breach of any undertaking, avoidance or repudiation, etc.**
- **Notice of exercise of trustee powers,**
- **Indemnity of trustee,**
- **Appointment of debenture Trustee as Attorney,**
- **Remuneration of Debenture Trustee,**
- **Description of Events of Default, which may arise due to Non-payment to debenture holders, breach of any undertaking, avoidance or repudiation, etc.**
- **Notice of exercise of trustee powers,**
- **Indemnity of trustee,**
- **Reimbursement of expenses incurred by the trustee,**
- **General covenants etc.**

**PUBLIC OR RIGHTS OFFER OF DEBENTURES**

SEBI has prescribed certain guidelines for issue of debt instruments in the case of listed companies. This is part of SEBI (Disclosure & Investor Protection) Guidelines, 2000. These are in addition to and not in derogation of other regulations discussed in this article.

The broad guidelines are as follows.

- **No company shall make a public or rights issue of debentures, unless credit rating of not less than investment grade is obtained from not less than two registered credit rating agencies and disclosed in the offer document. Where credit ratings have been obtained from more than two credit rating agencies, all the credit ratings including those not accepted are to be disclosed. All credit ratings obtained during the three years preceding the public or rights issue of debt instruments in respect of listed security are also to be disclosed;**

- **Appointment of debenture trustee is more relevant in the case of issue of debt instrument by a listed company because of public holding of a large number of debentures. The trust deed is required to be executed within three months from the closure of the issue.**

- **the Merchant Banker is required to send, along with the draft offer document to SEBI, a certificate from the Company’s bankers that the asset in respect of which security is to be created is free from any encumbrance and the same is adequate to ensure 100% asset cover for the debentures.**

- **The debenture trustee is required to obtain reports from the lead bank about the progress of the project for which funds have been raised through debentures and utilization thereof, supported by auditor’s certificate.**

- **Companies which have defaulted in payment of interest or redemption of debentures or creation of security cannot distribute dividend without the approval of debenture trustee and lead institution, if any.**

- **Dividend may be distributed from out of profits of the current year only after transfer of requisite amount to Debenture Redemption Reserve(DRR).**

- **The offer document should specifically state the asset in respect of which security is to be created, the ranking of the asset, the asset cover to be maintained etc.**

- **The issue proceeds should be kept in an escrow account until the documents for creation of security, as stated in the offer document, are executed.**

- **In the case of issue of debentures having maturity value of less than 18 months, a charge has to be created on the asset of the company and file necessary return with the ROC. In such cases appointment of debenture trustee does not appear to be necessary.**

- **Where no charge is created, the issuer company will have to ensure compliance with the Companies(Acceptance of Deposits) Rules, 1975 as unsecured debentures/bonds are treated as “deposits”;**

- **In the case of Fully Convertible Debentures(FCDs), if the conversion takes place on or after 18 months from the date of allotment, but before 36 months, such conversion, in whole or in part, should be at the option of the debenture holders. Where conversion takes place after a period of more than 36 months, conversion shall be made with “put” and “call” option;**

**WHO CAN APPOINT DEBENTURE TRUSTEE ?

Creation of security means mortgaging the property in favor of Debenture Trustee for the benefit of debenture holders. This is an incidence of ownership of property and creation of security has to be done by the owner of the property. However, the debenture holders are beneficiaries and they have no access to mortgaged property. The Debenture Trustee holds the secured property on behalf of issuer of security and for benefit of debenture holders. In the event of default by the issuer of security, the Debenture Trustee will have the power and authority to bring the secured property to sale following the procedure in the Transfer of Property Act and the proceeds of sale will have to be applied to redeem the debentures. This is one of the powers conferred on the Debenture Trustee by the SEBI Regulations. Effective use of this power is possible if this power is included in the Debenture Trustee Agreement and a suitable power of attorney is executed by the issuer of debentures in favor of Debenture Trustee. This document has to be executed as a trust deed and not as a Mortgage deed or bond.**

**WHAT IF THE DEBENTURE HOLDER IS A NON-RESIDENT?**

These days large real estate development projects are financed by international banking institutions under the Special Economic Zone (SEZ) scheme by subscribing to mandatorily convertible debentures, as required under the FEMA. In this
event if the debenture holder is a non-resident, he cannot hold the mortgaged property as FEMA regulation prohibits a non-resident holding an immovable property in India. The definition of “transfer” in section 2(ze) of FEMA includes sale, purchase, exchange, mortgage, pledge, gift, loan or any other form of transfer of right, title, possession or lien. However, a non-resident debenture holder requires back up security till his debentures are converted into the equity shares of the Indian company. This can be achieved by appointing a Debenture Trustee so that he will be able to hold the secured property for the benefit of non-resident debenture holder. This does not attract FEMA provisions as the secured property is held by an Indian entity on behalf of an Indian company. Even the sale of secured property by the debenture Trustee, in the event of default by the Indian company will not attract FEMA provisions as the transaction will take place in India without the involvement of non-resident debenture holder. However remittance of sale proceeds to the non-resident debenture holder involves FEMA scanner and will have to be routed through the authorized dealer in foreign exchange as there is no automatic capital convertibility.

**STAMPING REQUIREMENTS**

In the matter of issue of debentures, there is Mortgage Deed (dealt with in Article 40) and Debenture (dealt with in Article 27) of the Indian Stamp Act. While the former document sets out the terms and conditions subject to which debentures have been issued including security, the latter document provides for transfer of debentures as a marketable security.

There are various forms for creation of security by way of mortgage. It may be with possession or without possession of property with reference to which mortgage has been created or proposed to be created. One of the simplest ways of creating mortgage is by deposit of title deeds in respect of secured asset and this has been dealt with in Article 6 of the Indian Stamp Act. Where the debt is repayable on demand or more than three months from the date of instrument evidencing the agreement, the stamp duty payable is the same as on the bill of exchange dealt in Article 13(b) of the said Act. Accordingly, upto rupees one thousand, it is five rupees and for every additional one thousand or part thereof, the duty payable is rupees five, where it is payable more than one year after date. The amount of duty payable will have to be worked on the total value of debentures.

Article 27 deals with stamp duty payable on the transfer of debentures as a marketable security by way of endorsement or by separate instrument of transfer. Rates of stamp duty are given in the Article. However, in the matter of issue of debenture certificate, there is an exemption. This exemption is applicable if the debenture certificate is issued by an incorporated company in terms of registered mortgage deed, duly stamped in respect of full amount of debentures and the debenture certificate is issued pursuant to the said mortgage deed.

The Proviso to Section 3 of the Indian Stamp Act which deals with liability of instruments to duty provides that no duty shall be chargeable in respect of any instrument executed by or on behalf or in favor of the Developer or Unit or in connection with the carrying out of purposes of the Special Economic Zone.

Section 8 of the Indian Stamp Act provides for a duty of one percent of the total value of debentures, Bonds or other securities issued by a local Authority for raising loan under the provisions of Local Authorities Loans Act, 1879 or any other law for the time being in force and such bonds, debentures or other securities need not be stamped and they are not chargeable with any further duty on renewal, Consolidation, sub-division or otherwise. There is also duty exemption in the case of issue of securities to the depositories under the Depositors Act including transfer of such securities.

In the Karnataka Stamp Act, 1957 item 6 of the Schedule deals with agreement relating to deposit of title deeds, pawn or pledge, that is to say, any instrument where such deposit has been made by way of security for repayment of money advanced or to be advanced by way of loan or existing or future debt, the stamp duty payable is Rupees 50 for an amount exceeding Rupees 10,000 (if drawn singly) or Rupees 25 (if drawn in set of two, for each part of the set) and for additional 10,000 or part thereof in excess of Rupees 10,000, it is Rupees 25 (if drawn singly) or 12.50 (if drawn in more than one set). This applies where the debt is repayable on demand or more than three months from the date of instrument evidencing the agreement.

**DEBENTURE CERTIFICATE**

The debenture certificate stands on a different footing. Before issue of certificate, the company will have to create a charge on the assets of the company by filing the required forms with the ROC. The certificate of charge will have to be reproduced on the back of the certificate as also major terms and conditions subject to which debentures have been issued. Section 113 of the Companies Act provides for issue of debenture certificate within three months from the date of allotment of debentures. However, the Company Law Board (this power is being shifted to Central Govt) may extend the period to a further period not exceeding nine months if it is satisfied that the company is not in a position to deliver the certificate within the aforesaid period of three months. Delay in creation of security may be one of the reasons for seeking extension of time.

**DEBENTURE REDEMPTION RESERVE**

Section 117C of the Companies Act requires that every company issuing debentures should create DRR for the purpose of redemption of debentures to which adequate amounts should be credited from the profits of the company until debentures are redeemed. This is a mandatory provision. SEBI regulations also
require companies issuing debentures to provide for DRR as required under the Companies Act. Even where debentures are compulsorily convertible into the equity shares of the debenture issuing company, as in the case of FEMA, creation of DRR is unavoidable till the date of conversion. However, after conversion of debentures, the amount in the DRR may be transferred to general reserve or in such other manner as the Board thinks fit and proper. The amount credited to DRR cannot be utilized except for the redemption of debentures.

DCA Circular No. 9/2002 dated 18-4-2002 provides some relief as under in the matter of DRR in the case of banking Institutions, All India Financial Institutions, NBFCs and others keeping in view the genuine problems likely to be caused to these institutions:

(a) No DRR is required for debentures issued by All India Financial institutions (AIFIs)regulated by RBI and banking companies for both public as well as privately placed debentures. For other FIs within the meaning of section 4A, DRR will be as applicable to NBFCs registered with RBI.

(b) For NBFCs registered with RBI under section 45-1A of the RBI Act, [inserted by the RBI (Amendment) Act, 1997] the adequacy of DRR will be 50% of the value of debentures issued through public issue as per present SEBI (Disclosure and Investor Protection) Guidelines, 2000 and no DRR is required in the case of privately placed debentures.

(c) For manufacturing and infrastructure companies, the adequacy of DRR will be 50% of the value of debentures issued through public issue and 25% for privately placed debentures.

(d) Section 117C will apply to debentures issued and pending to be redeemed and such DRR is required to be created for debentures issued prior to 13.12.2000 and pending redemption subject to clarification issued herein.

(e) Section 117C will apply to non-convertible portion of debentures issued whether they are fully or partly convertible.

By another circular issued by DCA [General circular No. 4/2003 dated 16.1.2003] the requirement of DRR has been modified in the case of Housing Finance Companies. In the case of these companies registered with National Housing Bank under Housing Finance Companies (NHB) Directions, 2001 the adequacy of DRR will be 50% of the value of debentures through public issues and no DRR is required in the case of privately placed debentures.

It is also clarified by the DCA that since DRR will have to be carved out of profits of the company, there is no obligation to create DRR if there is no profit in a particular year.

DRR is an insurance and it enables the issuer of security to redeem the debentures and fulfill its obligation. If, for any reason, the issuer of security fails to redeem the debentures, the aggrieved party may approach CLB/Tribunal which will issue a direction to the company to redeem the debentures forthwith together with interest. Failure to do so is punishable with imprisonment extending upto three years and fine of not less than five hundred rupees for each day of default (section 117C of the Act).

UNSECURED DEBENTURES

Companies may also issue unsecured/subordinated debt instruments/obligations and these are not considered as public deposits under section 58A of the Companies Act. However, such instruments have to be subscribed by qualified institutional investors or others who have given positive consent for subscribing to such unsecured/subordinated debt instruments.

In the case of companies issuing debt instruments like debentures having maturity of less than 18 months, there is a facility of creating a charge on the assets of the company, instead of having to create mortgage and appoint Debenture Trustee for its assets. However, where no charge is created as aforesaid, the issuer company is required to ensure compliance with the provisions of Companies (Acceptance of Deposits) Rules as such unsecured debentures/bonds are treated as “deposits” as provided in Chapter X of SEBI (Disclosure & Investor Protection) Guidelines, 2000.

Sections 117 to 123 of the Companies Act, 1956 provide for special provisions regarding debentures. These provisions are also applicable to unlisted public companies and private limited companies. The provisions of the articles of the company should also be kept in view. The manufacturing and Infrastructure companies can avail of lower percentage of DRR as the DCA circular does not make any distinction between listed and unlisted companies in its circulars referred to above and the relaxation is also applicable for privately placed debentures by private companies.

CONCLUSION

Issue of Debentures, whether redeemable or convertible involves compliance with the substantive and procedural aspects of law. Documentation is equally important. The benefit of raising loan capital lies in the fact that it does not disturb equity structure of the company and consequently the existing management. However, the success of a debenture issue, be it private or public issue depends, to a large extent, on the goodwill and rapport built up by the company with the investing public. Another aspect of the matter is the protection of interest of debenture holders. This is sought to be achieved by an independent Debenture Trustee who is required to be appointed by listed companies in regard to public issue or further issue of capital as the number of debenture holders are considerably large. Creation of DRR which is a statutory obligation is intended to provide liquid resource built out of profits of a company for redemption of debentures.