Security Interests

Their types and uses in the commercial world

Shraddha Shivani | Executive
Vinod Kothari & Company

Kolkata:
1006-1009, Krishna Building
224 AJC Bose Road
Kolkata – 700 017
Phone: 033 2281 3742
Email:
corplaw@vinodkothari.com

New Delhi:
A-467, First Floor,
Defence Colony,
New Delhi-110024
Phone: 011 41315340
Email:
delhi@vinodkothari.com

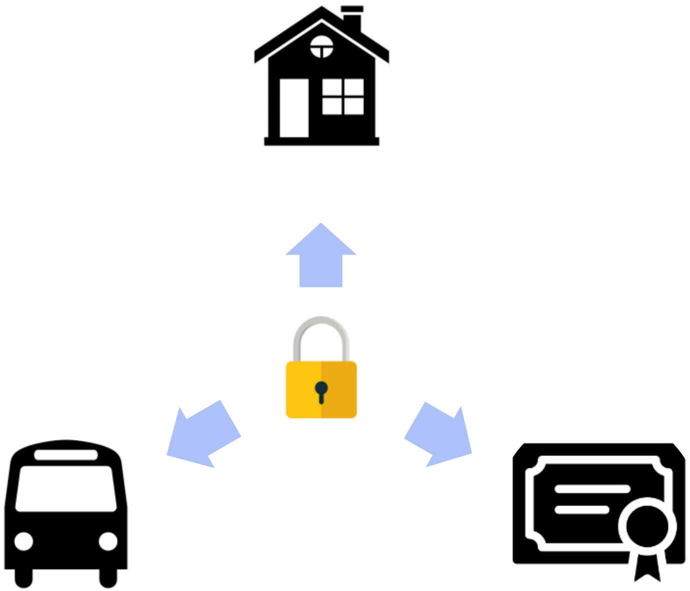
Mumbai:
403-406, Shreyas Chambers
175, D N Road, Fort
Mumbai
Phone: 022 2261 4021
Email:
mumbai@vinodkothari.com

What is a security interest?

Defined in section 2(1)(zf) of SARFAESI, 2002

A security interest is:

- The right/ title/ interest over a property
- Created in favour of a creditor
- As collateral for financial assistance granted



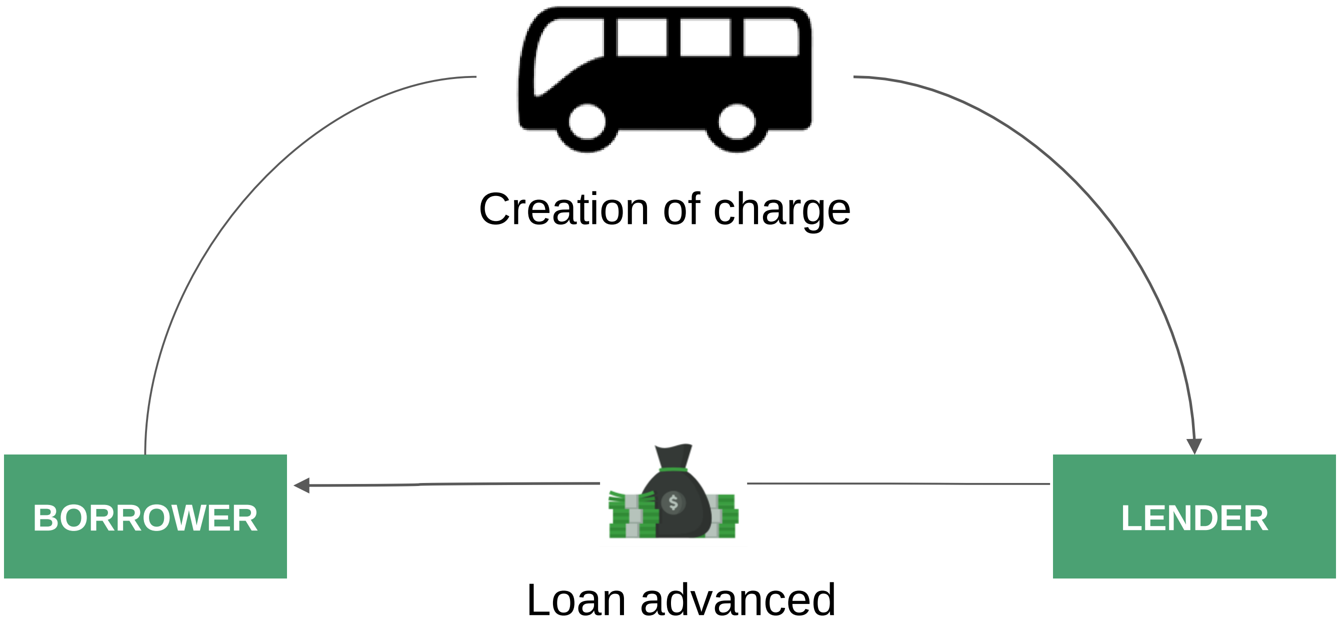
Types of Security Interests

Hypothecation

Hupothḗkē [Greek]

Section 2(n) , SARFAESI Act, 2002

The charge upon any movable property, existing or future, created by a borrower without delivery of possession of the movable property, as a security for financial assistance



- Possession remains with debtor.

- In Gopal Singh Hira Singh v PNB, the Delhi HC held that the borrower holds the actual physical possession of the goods not in his own right as the owner but as the agent of the hypothecatee.

- Upon default to repay the debt within the stipulated time, the creditor has the option to recover his dues by way of sale of the hypothecated property. Different High Courts have taken different approach on whether financier has to approach court to take possession of hypothecated goods.

- Rights and remedies of a hypothecatee are regulated by the terms of the deed of hypothecation.

Case study - Equipment finance

Any business owner understands the importance of having the latest technology tools and equipment for their business. These may include medical equipment, computers and office equipment, trucks or other vehicles, data processing machines, servers, heavy machinery, etc.

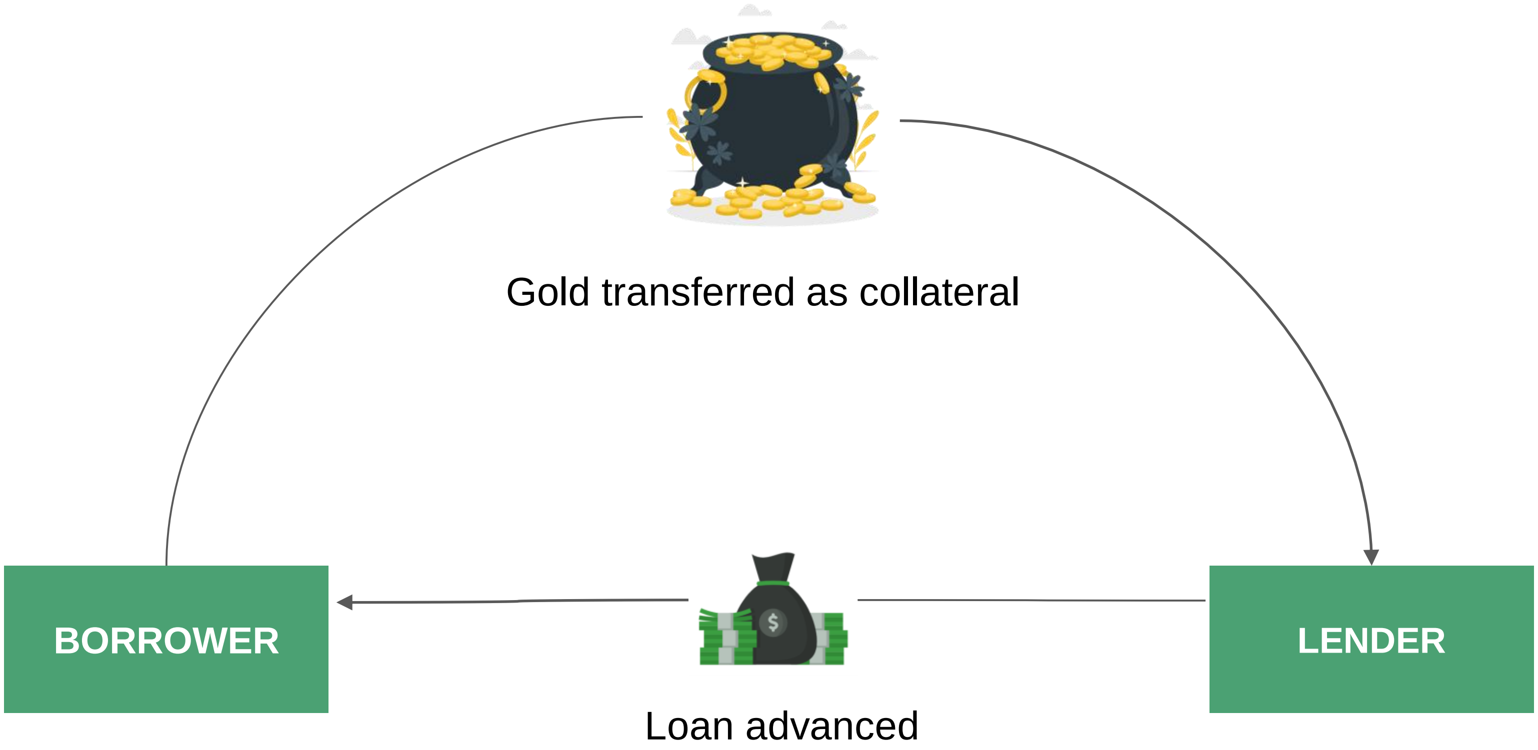
Equipment loans can be used to fund the purchase or replacement of the required machinery and equipment. The purchased equipment acts as a collateral and hence there is no additional security/collateral needed. It helps to spread the cost of equipment over many months or years.

Pledge

Plegge [French]

Section 172 – 179, Indian Contract Act 1872

The delivery of property as security for payment of debt or performance of a promise.



- Governed by provisions of the Indian Contract Act, 1872

- Essential characteristics:
  - Delivery (Actual or Constructive)
  - Special property in the pledged goods

- Pledgee’s Rights:
  - Right of Possession
  - Right of disposition to a third party

- Pledger's Rights:
  - To receive notice of sale
  - To redeem pledged goods till actual sale to a third party.

Case Study - Negotiable Warehouse Receipts

Farmer deposits his produce in a WDRA accredited warehouse, which issues him a warehouse receipt. Farmer takes the receipt, which has all the necessary details like quality and quantity of the produce, to the bank. Bank offers credit facility against that receipt up to 70 per cent of the value of the collateral with the warehouse.

The farmer can use the fund for his consumption needs and inputs for the next season. Meanwhile, farmer keeps an eye on the price, and sells the produce, wholly or partly for a price that he thinks is right, and repays the bank.

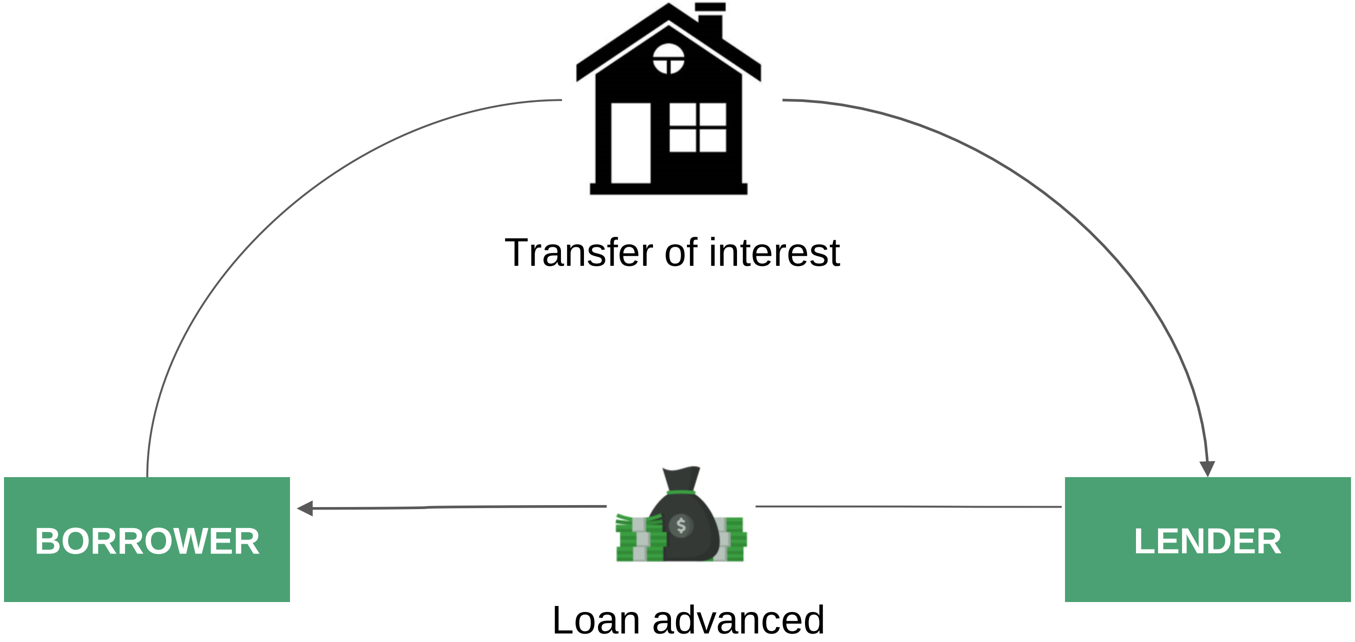
The average tenor of loan against WHR is around six months.

Mortgage

Mort Gaige [French]

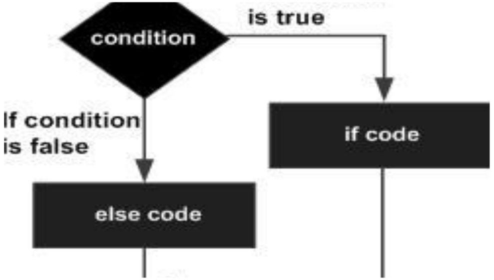
Section 58 - 61, The Transfer of Property Act, 1882

The transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability.



Types of Mortgages

Simple Mortgage



Mortgage by conditional sale

Equitable Mortgage

English Mortgage

Usufructuary Mortgage

Anomalous Mortgage

Cost Analysis - Simple vs Equitable

- Under the Maharashtra Stamp Act, 1958, stamp duty of 3-5% of the value of property is to be paid on a mortgage deed where possession is transferred and where the possession is not so transferred, 0.5% of loan value subject to a maximum of 10 lakh rupees. On the other hand, stamp duty for executing a memorandum of deposit under an equitable mortgage is 0.1% to 0.2% of the loan amount depending on the loan amount subject to a maximum of 10 lakh rupees.

- Under the Delhi Stamp Act, stamp duty of 5% of the loan amount is to be paid on a mortgage deed. On the other hand, stamp duty for executing a memorandum of deposit under an equitable mortgage is 0.5% depending on the loan amount subject to a maximum of 50 thousand rupees.

- Under the Karnataka Stamp Act, 1957, stamp duty of 5% of loan value is to be paid on a mortgage deed where possession is transferred and where the possession is not so transferred, 0.5% of loan value. On the other hand, stamp duty for executing a memorandum of deposit under an equitable mortgage is 0.1% to 0.2% depending on the loan amount subject to a maximum of 10 lakh rupees.

Important terms

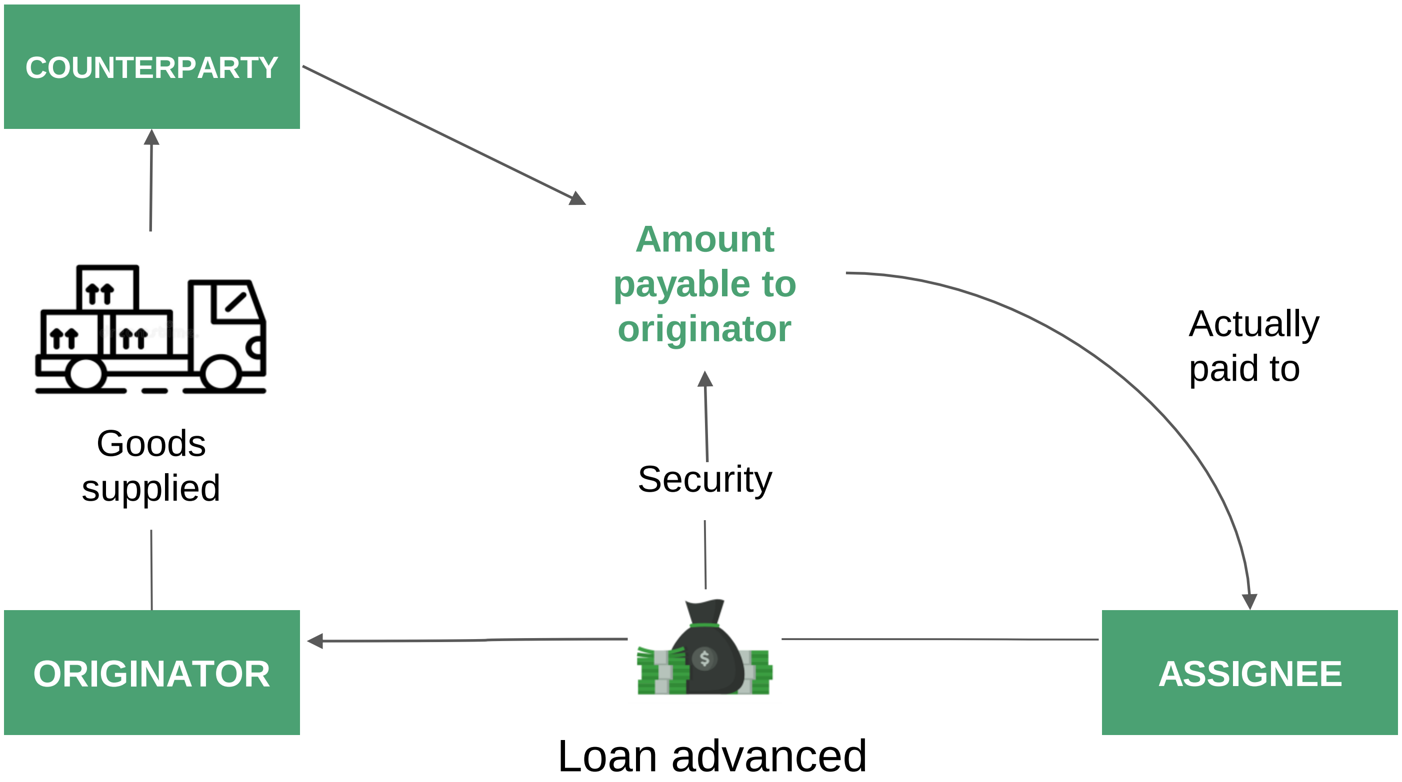
Right of Redemption	Right of Foreclosure	Right of sale
Right of a borrower to redeem his property on repayment of debt granted by section 60 of the Transfer of Property Act, 1882.	Causes the mortgagee to become the absolute owner of the mortgaged property by extinguishing the mortgagor's right to redeem.	Right to cause sale by obtaining a decree of Court.

Assignment

Assignare [Latin]

Section 130, The Transfer of Property Act, 1882

The transfer of receivables



Types of assignments

- Legal Assignment: Governed by provisions of Transfer of Property Act, 1882

- Equitable assignment: If a transfer is not covered within the ambit of Section 130, then it may independently and separately operate as an equitable assignment of actionable claim.

Case study - Road construction

Contractor may assign its right to receive payments under Road Development/ Construction Agreement to any person providing financing to the Contractor in connection with the performance of the Contractor's obligations under the Agreement.

Charge

Chargier [French]

Section 100, The Transfer of Property Act, 1882

Section 100 of Transfer of Property Act, 1882 - Where immoveable property of one person is by act of parties or operation of law made security for the payment of money to another, and the transaction does not amount to a mortgage, the latter person is said to have a charge on the property.

Under Section 2(16) of Companies Act, ‘charge’ is defined as an interest or lien created on the property or assets of a company or any of its undertakings or both as security and includes a mortgage.

Types of charges

- Fixed Charge: Placed on ascertainable or tangible assets like land, buildings, machinery, goodwill, copyright, etc. The borrower is just left with the possession of the asset, but the lender retains complete control. borrower doesn’t have right to sell, transfer, or dispose of the property without first obtaining approval of the.

- Floating Charge: Placed on unascertainable assets whose value keeps changing.

Case study - Uncalled Capital

A company may create a charge over its uncalled capital or on calls made but not paid in the same way as it would any of its other assets. The lender would have the right to recover his debt in the event of default from such calls or forfeiture of shares, if any.

Lien

Ligare [Latin]

Lien is simply a right to possess and retain property until some claim attaching to it is satisfied or discharged.

Indian Contract Act, 1872:

- Section 170: Bailee's Particular Lien i.e. involving the exercise of labour or skill in respect of the goods bailed
- Section 171: General lien of bankers, factors, wharfingers, attorneys and policy-broker

Section 47 of Sale of Goods Act, 1930:

Unpaid seller may retain possession of goods when:

- Sold without stipulation for credit; or
- Term of credit expired; or
- Buyer becomes insolvent

Case study - IPO funding

IPO funding is a short-term loan provided by a lending institution which allows an investor to invest a higher amount in an IPO. One the investor is alloted shares pursuant to IPO, the shares are immediately sold and the proceeds are utilized to repay the loan of the lender and balance, if any, goes to the investor.

In case, the amount realised from shares is not sufficient to repay the loan, the borrower will have to bring in money to meet the shortfall in the total loan amount and the money released from the sale.

Security interests over Intellectual Property Rights

Prima facie reading of statutes shows that security can be created over intellectual property rights:

Section 2(1)(t) of the SARFAESI Act defines the expression property and specifically includes intangible assets

Patents Act, 1970 and the Designs Act, 2000 contemplate the record of security interest created by way of an assignment, license, mortgage or otherwise. These legislations mandate that the creation of security interest over the patent / design should be recorded in writing and communicated to the Controller of Patents / Designs.

Trade Marks Act, 1999 and the Copyright Act, 1957 are silent on the creation or record of security interest over trademarks / copyrights. These enactments, however, contain provisions pertaining to the assignment of rights in registered or unregistered trademarks or copyrights; and require that such assignment must be in writing.

Is the creation of security interests enough?

Perfection of security interest means the steps required to be taken to make a security interest enforceable.

Companies Act, 2013	SARFAESI Act, 2002	Insolvency and Bankruptcy Code, 2016
Section 77	Section 26D	Section 215, Regulation 21 of the IBBI (Liquidation Process) Regulations, 2016
Company creating a charge on its property or assets or any of its undertakings must have it registered with the RoC within the prescribed time	Secured creditor must register security interest with the Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI)	Financial Creditors must submit financial information of indebtedness availed and information relating to assets in relation to which any security interest has been created to Information Utilities like National e-Governance Services Ltd. (NeSL)
If not registered, such charge becomes void against the liquidator and any other creditors	Creditor will not be able to enforce its interest in the secured assets under the provisions of SARFAESI Act	Mandatory for a financial creditor to submit financial information to an Information Utility to initiate CIRP

Specific Registrations based on the nature of the asset

Immovable Property	- Creation of security interest over immovable property a mortgaged deed will have to be registered with the relevant jurisdictional sub-registrar of assurances within which the mortgaged land is situated, along with payment of state-specific registration fees;
Motor Vehicles	- Must be registered by the lender with State Motor Vehicles Registry as per the Section 51 of Motor Vehicles Act - Name of charge holder is noted in the registration certificate of the vehicle - Any subsequent transfer by borrower would require NOC from charge holder
Dematerialized Shares	Pledge of demat securities are required to be recorded with the depository.
There are also specific registration requirements for creation of charge over aircrafts, ships and vessels, and intellectual properties.	

Accounting for collateral and foreclosed property

Division III of Schedule III to the Companies Act, 2013 prescribes a separate disclosure for secured and unsecured loans and borrowings.

IFRS 7 specifies that an entity must disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

Where the entity has acquired complete right over the foreclosed asset, it shall derecognise the loan asset and recognise the foreclosed asset in its books.

Snapshot of different types of security interests

	Hypothecation	Pledge	Mortgage	Assignment	Charge	Lien
Possessory	No	Yes	Depends	N/A	No	Yes
Underlying asset	Movable	Movable	Movable/ Immovable	Intangible	Movable/ Immovable	Movable
Right to sell/ cause sell	Yes	Yes	Yes	Yes	Yes	No

Release of security interest

- All security interests recorded with the ROC and CERSAI must be released by filing relevant charge satisfaction forms.

- In an equitable mortgage, the title deeds that were delivered to the lender are returned to the security provider. If the equitable mortgage is registered, then a deed of release is executed between the mortgagor and the mortgagee and is registered with the relevant land revenue authority.

- Where the shares are in physical form, the share certificates must be returned to the pledgor. If the shares are in dematerialised form, the necessary forms must be filed with the depository participant for release. The power of attorney issued under the pledge agreement must also be returned or cancelled.