Article

MCA Circular widens scope for secured corporate debentures, grants exemption from Public Deposit norms

- *However, flawed language may create confusion*

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Analytical Speaking

The Ministry of Corporate Affairs, vide a notification dated 21st March 2013[1] (**"Notification"**), has made a change in Companies (Acceptance of Deposits) Rules 1975 (**"Deposit Rules"**). The apparent purpose of the Notification is to widen the scope for companies to issue secured debentures, thereby widening the bond market. This seems to be a part of the recent measures[2] to widen the bond market in the country.

However, first of all, the language of the Notification is itself flawed and may lead to confusion – as illustrated later in this article. Second and more significant, the insistence of the lawmakers on "secured debentures" needs to go away completely, as corporate debentures are essentially used world-over as unsecured debt instrument.

The bond market in India is far from developed. Despite considerable interest in bond market development, the corporate bond market accounted for only 3.9% of the sources of funds of large Indian companies. A perusal of the various sources of raising resources in the domestic market reveals that the large non-financial corporates have been raising only about 4% through the debt route while the bank borrowings and foreign currency borrowings account for 17.8% and 3.2% respectively as on March 31, 2011. The share of bonds as a percentage of total debts in India account for only 4% whereas in countries like in China, the size is 17%, in US, it is 11% and in Japan the bonds constitutes 7% of its total debt market for the FY 2010-11. In addition, the bond market is primarily dominated by banks and NBFCs; hence, bonds have hardly been used by corporates[3].

Why are debentures "public deposits"?

It may sound queer as to how debentures are treated as public deposits at all. However, the definition of the term "deposit" in corporate laws in India is much wider than what is commonly thought. Any amount received, refundable with or without interest, is a deposit. There are certain exceptions laid down in Rule 2 (b) of

[1] http://www.mca.gov.in/Ministry/pdf/noti_Rules_20130010_dated_21mar2013.pdf

[2] The Finance Minister in course of his Budget speech referred to several measures for promoting the bond market, primarily being the starting of debt segment in stock exchanges. Recently, debenture redemption reserve requirements have also been changed. On DRR requirements, as amended, see our article at http://india-financing.com/staff-publications-corporate-law.html

[3] See our article on "'Corporate Bond Market-Removing the Bottlenecks' at http://india-financing.com/Corporate_Bond_Market-Removing_the_Bottlenecks.pdf

the Deposit Rules. Hence, even if an amount is raised by issue of debentures, it is still a deposit, unless it falls in one of the exceptions listed in Rule 2 (b).

The change in law

Prior to the Notification, Rule 2(b)(x) of the Deposits Rules exempted debentures if:

> *"any amount raised by the issue of bonds or debentures secured by the mortgage of any immovable property of the company or with an option to convert them into shares in the company provided that in the case of such bonds or debentures secured by the mortgage of any immovable property the amount of such bonds or debentures shall not exceed the market value of such immovable property."*

As is evident, there were two exceptions – debentures secured by mortgage of immovable property, and convertible debentures.

However, with this Notification, Ministry has reworded and replaced the said Rule with the following:

> *"any amount raised by the issue of bonds or debentures secured by the mortgage of any fixed assets referred to in Schedule VI of the Act excluding intangible assets of the company or with an option to convert them into shares in the company:*
> *Provided that in the case of such bonds or debentures secured by the mortgage of any fixed assets referred to in Schedule VI or of the Act excluding intangible assets the amount of such bonds or debentures shall not exceed the market value of such fixed assets."*

As an effect of the Notification, now, the issue of debentures or bonds will be exempt from the Deposit Rules if: a) the issue is secured by mortgage of *any fixed asset of the company as referred in Schedule VI having market value more or equal to the value of the issue*; or b) the issue is of the convertible debentures.

Since the law has been changed from "*mortgage of immovable property*" to "*mortgage of fixed assets*", it appears that the charge may be created on any of the fixed assets of the company. However, there is a significant distinction between charge and mortgage. In common parlance, the word "mortgage" is associated with

immovable property. Technically, there is nothing in law to prevent a mortgage being done with respect to movable property as well; however, mortgages of movable property are rare. So much so, that many people even fail to realize that there is anything called mortgage of movables. In fact, the word *chattel mortgage* is as old as the whole concept of mortgages[4].

It was not important for the MCA to use the expression "mortgage of fixed assets", as the idea may not have been to limit the issue of debentures to only mortgage, and not charge, over fixed assets. Mortgages of movable property are so common that such an intent could not have existed. The error perhaps occurred only because someone was replacing words in the old definition, and simply ended up replacing "immovable property" by "fixed assets". In result, most users will keep wondering as to how to create a mortgage of fixed assets. Stamp duty implications will also be a challenge.

Meaning of 'mortgage of fixed assets'

The significant difference between mortgage and charge is that mortgage is a transfer of specific property, whereas a charge is a merely lien or obligation upon property to discharge a claim. The distinction between a sale, mortgage and charge needs to be clearly understood – sale is an absolute transfer of property, mortgage is specific transfer (that is, transfer only for securing a debt) in property, and a charge is a mere lien or obligation on property to secure a debt.

More clearly, in a sale, there is no underlying debt and consideration for sale flows from the buyer to the seller in lieu of transfer of absolute ownership of the property sold. As also defined in ***Benjamin on Sale***, 8th Edition as:

> *"…Hence it follows that, to constitute a valid sale, there must be a concurrence of the following elements viz. (1) Parties competent to contract; (2) mutual assent; (3) a thing,* ***the absolute or general property in which is transferred from the seller to the buyer****; and (4) a price in money paid or promised."*

[4] For a brief description of mortgages of movable properties, see Vinod Kothari; *Securitisation, Asset Reconstruction and Enforcement of Security Interests*, 2010, p. 530, 598

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A 'mortgage' has been defined in section 58(a) of the Transfer of Property Act, 1882 as:

> *"A mortgage is 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."*

Therefore, in case of mortgage of immovable property, there is a transfer of interest: that is, the property moves from the mortgagor to the mortgagee, but the transfer is only for the purpose of securing a debt. That is to say, the transfer is not absolute: it is a specific transfer. The property reverts to the owner once the debt is satisfied.

If the above definition of mortgage is read in context of movable property, it is to read as: *A mortgage is the **transfer of an interest in specific movable 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.* Thus, to create a mortgage, the borrower/debtor not only creates an encumbrance on the property, but makes a specific transfer of property itself. Transfer of property does not necessarily mean transfer of ownership – transfer of usufruct, transfer of possessory rights, or transfer of any interest in property also creates a mortgage.

On the other hand, a charge, there is no transfer of interest in property at all. In fact, in case of charges, the property may be both present and future, as is the case with floating charges. The concept of floating charge does not fit into the meaning of mortgages, as only specific property can be mortgaged.

How is mortgage of movable property done?

Since the meaning of a "mortgage" is transfer, there must be a transfer of property from the mortgagor to mortgagee to create a mortgage. This transfer will get reversed, or the property will get re-transferred, if the debt in question is discharged. Hence, the easiest way to create a mortgage in case of movable properties is by way of a conditional sale.

A mortgage by conditional sale has been defined in Section 58(c) of the Transfer of Property Act as:

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> *"Where, the mortgagor ostensibly sells the mortgaged property –on condition that on default of payment of the mortgage-money on a certain date the sale shall become absolute, or on condition that on such payment being made the sale shall become void, or on condition that on such payment being made the buyer shall transfer the property to the seller, the transaction is called a mortgage by conditional sale and the mortgagee a mortgagee by conditional sale:*
>
> *Provided that no such transaction shall be deemed to be a mortgage, unless the condition is embodied in the document which effects or purports to effect the sale."*

To conclude above, we can say that whereby the mortgagor transfers the property to the mortgagee upfront, and agrees with the mortgagee that in the event the mortgagor defaults in payment of the mortgage money on the due date, the conditional sale done upfront will become absolute, and if the debt is discharged, the conditional sale will either get reversed or get cancelled, we have a case of mortgage of movable property.

The issue of debentures secured by movable property by creating mortgage by conditional sale serves the purpose of all the parties: the issuers, the investors and the lawmakers as security is created for a value more or equals to the issue of debentures makes the investor comfortable and is exempted from the Deposit Rules, and at the same time, issuers are benefitted by creating mortgage on movable properties.

Though there is a transfer of property in case of a mortgage, such transfer is not a "sale" from the viewpoint of VAT or sales-tax laws, as the definition of "sale" under these laws specifically excludes mortgages.

Other laws affecting debentures

Following are the other guidelines, rules or directions attracting issue debentures:

Issue of debentures by listed companies:
Issue of convertible debentures by listed companies attracts provisions of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 along with provisions of Companies Act. Issue of short term non-convertible debentures

(having an initial maturity up to 12 months) will require compliance of Issuance of Non-Convertible Debentures (Reserve Bank) Directions, 2010. If the issue of NCDs is to be listed (whether public or privately placed issue) or is a public issue, SEBI (Issue and Listing of Debt Securities) Regulations, 2008 is required to be complied with.

Issue by unlisted public companies:

The issue of convertible debentures by unlisted public companies on preferential basis is governed by Unlisted Public Companies (Preferential Allotment) Rules, 2003, amended from time to time. Issue of short term non-convertible debentures (having an initial maturity up to 12 months) will require compliance of Issuance of Non-Convertible Debentures (Reserve Bank) Directions, 2010. If the issue of NCDs is to be listed (whether public or privately placed issue) or is a public issue, SEBI (Issue and Listing of Debt Securities) Regulations, 2008 is required to be complied with.

Issue of debentures by private companies:

Private companies are prohibited from accepting deposits, hence, such companies can issue only either convertible debentures or non convertible secured debentures as per the Notification.

As such, no regulations have been provided for issue of debentures, whether convertible or non convertible, by private companies. However, private companies can issue to a maximum of 49 people as beyond which the issue will be deemed public issue and SEBI (Issue and Listing of Debt Securities) Regulations, 2008 will be required to be complied with. If private companies are to get its issue of NCDs listed, then also, it needs to abide by the SEBI (Issue and Listing of Debt Securities) Regulations, 2008.

Implications of stamp laws in case of mortgage debentures

The mortgage debentures may attract duty as payable on: (a) creation of the mortgage; and (b) the issuance of debenture certificate.

As the debentures certificate is a debt certificate and hence, is liable to stamp duty as applicable in the state where the registered office of the issuing company is situated. In addition, in case of debentures secured by mortgage of specific property, applicable stamp duty on mortgage deed shall also be required to be paid.

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Generally, mortgage is created on immovable property, however, the definition of 'mortgage deed' as defined in Indian Stamp Act, 1899 reads as:

> *"Mortgage-deed includes every instrument whereby, for the purpose of securing money advanced, or to be advanced, by way of loan, or an existing or future debt, or the performance of an engagement, one person transfers, or creates, to, or in favour of, another, a right over or in respect of specified property".*

The definition, as is evident, is not limited to immovable property – hence, even a mortgage of movable property, if done by way of a mortgage deed, may be liable to stamp duty. It is a different, and contentious, issue, whether a mortgage of movable property requires a *deed* at all, since there are no mandatory provisions requiring a written instrument in case of a mortgage of movable property, unlike section 59 of the Transfer of Property Act.

The definition is quite clear that the mortgage debentures shall be chargeable, however, subject to applicable stamp acts in different states. In terms of Article 23A of the said Act, instruments of mortgages of marketable securities are to be charged with such stamp duty as applicable on normal agreements.

However, different states have different stamp duties and different charging rule, so issuer has to carefully see the stamp duty implications before considering mortgage debentures. For example, Article 27 of Schedule IA of the West Bengal Stamp Act includes mortgage debentures also within the article specified for the marketable debentures and also provides duty for mortgage deeds. Delhi Stamp Act also has the same provision as there in West Bengal Stamp Act. Schedule I of Bombay Stamp Act provides Article 54 under which security bonds or mortgage deeds are stamp able as per the specified rates.

While the intent of the MCA in extending the benefit of issuing secured debentures to all fixed assets of the company is laudable, the unwarranted use of the word *mortgage* may greatly curtail the extension of the benefit, particularly due to the stamp duty unclarity highlighted above.

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Practical implications of the Notification

The Notification has provided that the issue of bonds or debentures secured by fixed assets having same or more value as of the issue shall be exempted from the Deposit Rules. Below we discuss the applicability of the exemption in some practical situations:

- A company is issuing NCDs for Rs 100, secured by fixed assets of Rs 100, this will be exempted from Deposit Rules.
- An issuer is issuing NCDs of Rs 100, secured by fixed assets having book value of Rs 80 but market value of Rs 100. This will be exempted as the Notification exempts the issues secured by fixed assets having same or more market value.
- Issuer is issuing NCDs of Rs 100, secured by fixed assets having book value of Rs 100 but the market value of such assets is Rs 80. This will not be exempted as Notification speaks about market value of secured assets.
- Issuer is issuing NCDs of Rs 100, secured by fixed assets having market value of Rs 100, however, there are other charge holders holding floating charge over the same fixed assets – in our view, the creation of a floating charge (such as "all present and future assets of the company") does not prevent the company from creating a fixed charge. If the debentures in question are secured by fixed charge, the fixed charge takes priority over the floating charge, and the conditions of the Notification stand satisfied, hence, exempted.
- Issuer is issuing NCDs of Rs 100, secured by fixed assets having market value of Rs 100, however, there are other charge holders holding fixed charge over the same fixed assets. First of all, charge cannot be created in favour of debenture holders, unless existing creditors cede a charge. Even if charge is ceded, the amount of claims exceeds the market value of the assets – hence, such issue will not be exempted.
- Company is issuing NCDs of Rs 100, secured by fixed assets having market value of Rs 500, however, there are other charge holders holding fixed charge over the same fixed assets, with claims amounting to Rs 300. Assuming charge is ceded by the existing charge holders, the amount of claims is within the market value of the assets – hence, exempted. We advise that a secured debenture issuance should typically have an "asset cover" clause whereby the trustees will monitor the adherence of the asset cover condition by the issuer.

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- NCDs of Rs 10, secured by fixed assets having market value of Rs 100. However, after issue, the market value declines to Rs 80- exempt. As the Notification requires equal or more market value at the time of issue of debentures. Hence, debentures exempted at the time of issue will not be again treated as deposits if market value of security falls.

Conclusion

The Notification is to come into effect from the date of its publication in Official Gazette and as such the Notification has only been placed on MCA Portal, publication in Official Gazette is awaited. There is no doubt that the Notification will widen the scope of corporate bonds by exempting debentures secured by mortgage of 'fixed assets' instead of mortgage of 'immovable property'. Though the government is making continued efforts to improve the bond market of India and the issue of this Notification is yet another example of such efforts, however, such flawed language of the Notification will create confusion and uncertainty only until proper clarifications are issued in this regard.

Also see our other related write-ups:

- **Primer on debentures at http://india-financing.com/Primer_on_debentures.pdf**
- **Article on 'Corporate Bond Market-Removing the Bottlenecks' at http://india-financing.com/Corporate_Bond_Market-Removing_the_Bottlenecks.pdf**
- **Article on 'New DRR provisions- will they promote or demote the Bond Market' at http://india-financing.com/New_Debenture_Redemption_Reserve_Provisions-%20Will_they_promote_or_demote_the_Bond_Market.pdf**
- **Article on 'Understanding Compulsory Convertible Debentures' at http://india-financing.com/Understanding_Compulsory_Convertible_Debentures.pdf**
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