CHAPTER-III
CORPORATE SECURITIES

The most important thing in corporate world is securities which is basics survival of company, without which no one can imagine the capital market or the formation of company. It is only through corporate securities through which a company raises its finance. Public company issues prospectus in order to raise finance from the public. Through prospectus the company issues shares and pay a dividend on these share. This share is one form of securities. There are many forms of securities like debenture, stock, bond etc.

The term securities have been broadly defined under the companies act and includes:\n
a) Shares, stocks and bonds;

b) Debentures:

c) Mortgage deeds, instruments of pawn, pledge or hypothecation, and any other instruments creating or evidencing a charge or lien on the assets of the company; and

d) Instruments acknowledging loans to, or indebtedness of, the company and guaranteed by a third party, or entered into jointly with a third party.

Financial security is a legal document that represents either a flush or a creditor claim on a company corporate securities may, therefore, be divided into ownership and debt securities. Ownership securities consist of equity stock and preferred stock, while creditor securities consist of debentures. Each corporate securities has typical characteristics in so far as risk, income, control, ownership rights, repayment requirements, claims on assets and on profits are concerned.

A corporation may conveniently issue each class of securities in the market, for there is a class of investors for each class of securities because of their varying preferences for risk, income and control. There are various classes of buyers of securities in the capital market. The largest number of security buyers is that of individual investors. The investor seeks safety on his commitment and a

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reasonable certainly of a moderate but regular income. The speculator seeks large
profits, even though considerable risk may be involved in it. There are also special
classes of buyers, such as the stockholders, employers, customers and creditors
of a corporation and traders in the security market.

3.1 Classification of Securities

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(i) High Grade Investment Securities. These involve relatively little risk or loss
of principal, and offer a reasonable certainty of a steady income. They are
securities of conventional capitalist corporations. They teach the ultimate
investor through the agency of a reputable investment house, or are purchased
through organized security exchanges. The price admits of little or no gain
through appreciation; but the owner relies on stability of interest and
dividends for his income.

(ii) Low Grade Investment Securities. These include securities from which
some profit possibilities in addition to income may be reasonably expected.
They are marketed through established investment channels. There is a
possibility of gain through market appreciation, in addition to income which
becomes a source of attraction for the buyers.

(iii) Speculative Securities. These are securities from which a substantial risk
or loss of principal and regular income may arise. There is always a hope of
gain in the dealings of stick securities. They are usually distributed without
the cooperation of investment banking houses, and are more often bought in
the open market or direct from the corporation. They tend to be low in price,
fluctuate in the market, and involve a much greater risk than investment
securities. They are not worthless, nor are they a product of fraud. This class

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2 Ibid.
3 Ibid.
4 Ibid.
commonly includes securities of enterprises which are new and untried or which are in financial difficulties.

(iv) Fraudulent Securities\(^5\). These are worthless issues that represent nothing except the claims of dishonest promoters, on the one hand, and the cupidity or gullibility of buyers, on the other. Their main characteristic is that the transaction offers, for the investment of a small sum, extraordinarily high returns in a short time. In the words of Milo Kimoal "By skilful and extravagant claims, high pressure salesmen fire the imagination of the uninformed and exchange beautifully engraved, but worthless, certificates for cash.

The most common classification of capital stock is its division into equity stock, preferred stock and debentures. A corporation usually divides its stock into more than one class in order to attract capital. By classifying shares, funds can be raised from a wider circle of investors. These variations concern either the amount of income or the stability of income of the stockholder, his right of control, the risk he runs of the ultimate loss of his investment, the time during which he is a holder of his stock or other stocks. All corporations issue equity stock. Others issue equity and preferred stocks. The outstanding characteristics of equity stock is that its holders have an unlimited interest in corporate profits and losses, though they share in the dividends only after preference shareholders have been satisfied, and they participate in the distribution of assets after all the prior claims have been met. Equity shareholders always rank last for payments out of the proceeds of the dissolution of corporation. Equity stock, therefore, acts as a cushion in the event of the assets of the corporations undergoing shrinkage in value Corporate Securities can be divided into two types:

1. Equity Securities.
2. Debt Securities.

\(^5\) Ibid.
These two types of securities are traded in separate markets in stock exchanges. A number of companies, corporations and governments use these capital market securities to raise funds.

3.2 Equity Securities

There are two types of equity securities. They are common stock and preferred stock. An important distinction between these two forms of equity securities lies in the degree to which they participate in any distribution of earnings and capital and the priority given to each in any distribution of earnings. According to Section 85 of the Indian Companies Act of 1956, the share capital of a company consists only of two types of shares, namely (a) equity shares and (b) preference shares. The term share is defined by Section 2(46) of the Companies Act, 1956, to mean a share in the share capital of a company, and includes the stock, except where a distinction between the stock and a share is expressed or implied. It is a part or unit by which the share capital is divided. The Companies Act recognises two kinds of share capital, equity share capital and preference share capital. Equity shares are those, the holders of which do not enjoy any special privileges. They are entitled to surplus profits or to a portion thereof that may be available after all the preferential rights to dividend have been met. Equity share capital means all the share capital which is not preference share capital. Equity is "what remains of the business after the deduction of all liens or indebtedness." It is that part of capitalisation which is not a debt. It is ownership interest, the residual claim to assets and earnings, and contracts with debt which represents the first and fixed claim on both assets and earnings. If interest and principal payments on debt are not promptly met when due, bankruptcy or loss of control for the owner may occur. In general, equity capital may be represented by two main types of securities-preferred stock and equity stock. The ownership of a corporation is called equity. Equity is held by stockholders, each of whom owns one or more "shares" in the corporation. The term equity originates in the fact that the internal affairs of a corporation were originally administered in a court of equity as opposed to a court of law. This is also the origin of the

term *equity* when speaking of the ownership of the property that is mortgaged for debt, whether by the corporation or an individual. Ownership is "equity redemption of which can be cut-off only by foreclosure in court." Equity capital is also defined as the amount of the value of a property over and above the total liens and charges." In short, it is whatever remains in the way of assets after all the debts and other charges have been paid or provided for. Equity capital is, therefore, sometimes referred to as *residual capital*.

Equity shares are those which are other than preference shares. This definition suggests that there are two kinds of shares—preference shares and equity shares. This proposition is true, because under the present Act, a company cannot issue any other kind of share capital; but this restriction does not apply to a private company which is not a subsidiary of a public company. In fact, there are other kinds of shares—deferred shares; for example, the holders of such shares receive a dividend after its payment has been made on preference shares and equity shares. Such shareholders have chances of getting a good rate of dividend when the company is in a prosperous position.

Equity stockholders are residual claimants against the assets and income of the corporation. They have no claim on either until the claims of other security-holders have been fully met. Equity shares constitute property interest in the residual ownership of corporation and they make a real contribution to the capital of the corporation. They are ordinarily not supposed to enjoy any special privileges or rights. However, they do enjoy a set of voting privileges by virtue of charter or laws.

3.2.1 Advantages of Equity Shares

- **Risk Taker**- Equity shareholders are the main risk-takers in the corporation. The risk taken by equity shareholders is that, in a future quest of profits, the corporation may dissipate even the capital supplied by them.
- **No upper unit of return.** *There* is no upper limit on the amount of return that can be received by equity shareholders.

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7 www.businessindia.com visited on 26<sup>th</sup> Sept 2011 at 2P.M
Control the corporation - Control is always important everywhere, whether in politics, religion, or corporation finance. Theoretically, the control of the corporation is vested in equity shareholders, because it is they who vote for, and elect, the directors. The control of the corporation may be important; for, those who control can get in on the payroll as officers and influence the dividend policy.

No Obligation. The management is under no contractual obligations to pay a consideration for the use of equity capital.

Residual Claimants. Owners are residual claimants to all earnings after operating expenses, financial charges and taxes have been paid. Although equity shareholders come last, they have the advantage of receiving all that is left over.

No Stated Time. There is no stated time at which capital must be returned to the equity shareholders.

There is no undertaking by corporation to pay a fixed rate of dividend to its holder.

The directors enjoy the greatest latitude in framing a dividend policy;

Financial embarrassment can be easily avoided;

Equity stock does not carry fixed maturity and as such it requires refinancing of the corporation;

Equity stock is easier to sell than preferred stock or debt;

Equity stock is desired by a large number of investors;

The advantage of obtaining funds by the sale of additional equity capital is that these funds facilitate a more rapid growth of the company than would be otherwise possible; Additional equity capital expands the credit base of the corporation and enables it to borrow larger amounts of money; Where equity is sufficient to give an adequate credit base to support debt, the credit rating of the corporation with its suppliers and customers is improved;

Additional equity capital reduces the risks involved in the business. Where there are a large number of shareholders, the membership risk is
divided and the company can reasonably adopt a more venturesome policy;

- An addition to the number of shareholders enlarges the source of potential capital. Shareholders may provide additional capital for expansion as time goes on, if their investment experience in the company is good;
- The sale of equity interest brings into the company additional capital, together with counsel of new stockholders.

Equity stockholders are often described as the real masters of the company in the sense that they enjoy exclusive voting privileges. The Board of Directors are ordinarily representatives of equity stockholders; and it is naturally their tendency to protect the voting rights of equity stockholders as far as possible. These voting rights can be exercised with the help of proxies; that is, shareholders can give the right of vote at a meeting to all the stockholders who have voting rights by proxies. The corporation's charter often provides the right of accumulative voting, which is the right to cast any number of votes in favour of one item only; for example, in the event of electing 7 directors, the shareholder holding one share may be given the right of casting any or all votes in favour of one candidate.

3.2.2 Rights of Equity Shareholders\textsuperscript{9}

\textit{(a) The Right to Share in the Profits when Distributed as Dividends.} The right to share in corporate profits, when these are paid out as dividends, is one of the most important rights of equity shareholders. If the corporation is successful and makes a handsome profit, the stockholders expect the benefit of large dividends and an increase in the market value of their shares. \textit{Voting Rights}. One of the basic rights is the right to participate in the election of directors through the voting process. Stockholders vote on such matters as amending the charter, approving bonus plans for officers, etc. The proxy system enables the

\textsuperscript{9} Id 125 p.231
stockholders to cast their votes at meetings without attending them in person.

(b) Right to Inspect the Corporation's Books. Stockholders have the right to inspect the books of the corporation of which they are owners.

(c) Right to Prevent Acts which are Ultra Vires. They can prevent the corporation from engaging in acts which are ultra vires, that is, acts which are beyond the powers of the corporation as stated or implied in the charter.

(d) Right to Transfer Share. The right to transfer shares is one of the most important rights of the stockholders. The corporation does not make any promise to return their money at a specified time, for its funds are committed to the company permanently.

(e) Right to Share in the Proceeds upon Liquidation of the Company. When the corporation sells its assets and has repaid its creditors and preferred stockholders, equity shareholders are entitled to the remaining assets.

(f) Right to Receive a Certificate. The right to receive a stock certificate as evidence of ownership of share is another right of equity shareholders. They are usually given a certificate without question, as their right is taken for granted.

3.2.3 Disadvantages of Equity Capital

The disadvantages are:

i) Equity stock costs more than the preferred stock or debt securities;

ii) The cost of selling equity stock is generally higher than that of preferred stock or debt securities;

iii) Interest expenses are deductible for tax purposes. The interest substantially raises the cost of equity capital in relation to debt capital;

iv) Unless the management is careful in establishing the price of a new issue of equity shares, the existing stockholders will lose a portion of their net worth;

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10 Ibid
v) An additional issue of equity stock dilutes the control of the existing shareholders;

vi) Since equity stock shares equally in income, the management cannot increase a return on equity capital except by increasing the overall return on investment or by trading more heavily in the equity;

vii) Ownership interest is diluted as the equity base is expanded;

viii) Financial and operational flexibility is badly affected when the corporation gets deeply entrenched in its financial structure;

ix) The sale of a part interest in business reduces the original owners' participation in the profits of the company, though, of course, a refusal to sell additional shares may delay or prevent the natural growth of the corporation or enable the competitors to forge ahead and leave the company behind; and

x) A premature sale of stock in a growing company may make the original owner reluctant to further reduce his proportionate interest, even though funds may be urgently required for the growth and prosperity of the company.

3.3 Characteristics of Preferred Stock\textsuperscript{11}

(ii) Income. Preferred stock is ordinarily issued at a certain rate per cent. A specified amount based on the face value of preferred stock is made available as dividends each year to stockholders provided that the corporation makes profits and decides to distribute them to stockholders.

Preference shareholders get dividend first out of the profits of company, provider of course, that dividend is declared. When preference shares are of a cumulative type, then, if in any year, there is not enough profit to declare a dividend, preference shareholders cannot be paid dividends at the agreed rate, and arrears of dividends accumulate. And until all such arrears of dividends at the agreed rate are paid in full out of the profits of the company in the subsequent year or years, no dividend shall be payable to equity shareholders. In the case of non-cumulative type of preference shares, arrears

\textsuperscript{11} Id at 125 p-126
of dividend do not accumulate and shall not have to be paid out of the profits in the subsequent year or years.

(ii) Assets. Preferred stock has prior claim against proceeds up to the amount of par value of the stock at the time of the liquidation of corporation.

(iii) Control. Preferred stockholders are often given exclusive rights to select representatives to the Board of Directors in certain situations. They enjoy voting power over the actions of directors or equity stockholders on matters affecting the interests of preferred shareholders.

(iv) Right of conversion. A corporation's charter often allows the right of convertibility or convertible privileges to preferred stockholders. Preferred stockholders, at their option, may be allowed to switch over to equity stock. However, after this option has been exercised, the preferred stockholder becomes the equity stockholder and loses all the preferences which he had enjoyed earlier.

(v) Safeguards. Various safeguards are provided for preferred stockholders in order to preserve the integrity of their investment. For "example, the corporation may agree not to mortgage its property or issue fresh stock with priority over outstanding preferred stock. An assurance to maintain specific financial ratios may also be provided for in the preferred stock contracts. Moreover, preferred stockholders may be assured of the maintenance of reserves for future dividends for this class of stock before any distribution is made to equity stockholders. Ordinarily, these safeguards are restricted and not allowed to adversely affect the future growth of the corporation.

(vi) Restricted voting rights. Preference shareholders have restricted voting rights. They cannot vote on all matters, but only on those matters which affect their interests, e.g., reduction in share capital, winding up of the company, etc., but when cumulative preference shareholders do not get dividend for three consecutive years in a period of six years, they acquire full voting rights. Preferential rights may be added to the participating rights in some cases for example:
a) Holders of preference shares may be entitled to participation with holders of equity shares in the surplus profits of the company after the company has paid a fixed rate of dividend on preference shares. Such participation may be of two types-

(i) Preference shareholders participate in surplus profits at a fixed rate after the equity shareholders are paid a reasonable rate of dividend; and

(ii) Preference shareholders get dividend along with equity shareholders pari passu, i.e., at the same rate.

b) Holders of preference shares may also be entitled to participate in the surplus assets of the company when the company winds up its business. Creditors are fully paid out of the assets of the company; and, then, out of the surplus assets if any, preference shareholders get their capital repaid in full if there are still some surplus assets, preference shareholders together with equity shareholders, participate in them.

3.3.1 Type of Preferred Stock

(i) **Preferred as to Dividend** :- Preference stock may have a when a dividend is declared. Preference does not mean that a specified dividend is guaranteed. It merely means that, if any earnings are distributed as dividend, preference stockholder will get the first preference dividend payment.

(ii) **Cumulative Preferred Stock** :- Cumulative preferred stock is one on which all dividends are distributed to other stockholders. When unpaid, it is considered as a contingent claim on future earnings, and this claim accumulates from year to year for the benefit of preferred stockholders. Unpaid dividends are allowed to accumulate in the subsequent year to years, as the case may be.

(iii) **Non-Cumulative Preferred Stock** :- Where the corporation's contracts specify directly or by implication that dividends will not be allowed to

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12 Ibid
accumulate on preference shares, such preferred stock is called *non-cumulative* and dividends not paid in any year are lost for ever. When a preferred stock contract specifies that the dividend shall be *non-cumulative*, the dividend not paid in any year will be lost to preferred stockholders for ever.

*(iv) Participating Preference Shares* :- Most preferred stock contracts specifically lay down conditions for participation. Preferred stock is then entitled to get its contractual rate of dividend, and thereafter both common and preferred stocks call for a further distribution. This is simple or ordinary participation. Preferred stockholders participate equally with equity stockholders in the profits over and above the specified rate of dividend on preferred stock and the rate decided for equity stock. Suppose a 9 per cent participating preferred stock is issued. In that case, participating preferred stockholders will be paid 9 per cent dividend at the first distribution. When there are residual profits to be distributed, they would be distributed rate ably among all the stockholders, both preferred and equity, in the ratable proportions. However, the process provisions for the distribution of dividend are determined by the corporation's charter.

*(v) Non-Participating Preferred Stock* :- Sometimes, the terms of the contract may provide specifically that preferred stock will get a preferential rate of dividend but that any further distribution of dividend will go to the common stock. Such preferred stock is non-participating.

*(vi) Immediately Participating Stock* :- If the arrangement is for preferred stockholders who receive a specified rate of dividend and thereafter all the dividends are allotted to all the stocks, the preferred stock is said to *be immediate* participating.

*(vii) Preferred Stock in Series* :- The corporation's laws or some state provide that preferred stock may be issued in series with such preferences, restrictions and limitations as the corporation may fix
from time to time by a resolution of the Board of Directors. As participation in corporate income, preferences and other privileges are not set forth in the certificate of incorporation, this form of stock is sometimes called a *blanket* stock.

(i) *Irredeemable Preferred Stock*. Ordinarily, preferred stock is irredeemable, unless otherwise stated in the Corporate charter.

(ii) *Reedmable* - which can be redeemed after a certain duration.

### 3.3.2 Advantages

The advantages of preferred stock are:

a) Preferred stock dividends are fixed:

b) The management can use preferred stock to trade in equity;

c) The management uses the device without having to lose control of the company;

d) The cost of preferred stock is usually lower than that of equity stock and

e) It is possible to tap institutional investor for the purchase of preferred stock.

### 3.3.3 Disadvantages

Preferred stock suffers has following disadvantages in respect of control, income and redemption.

1. Control- preferred stockholders are ordinarily denied the right to vote except under specific conditions. They are allowed to vote only to matters affecting their interests, as a result of which equity stockholders often dictate the policies of the corporation.

2. Income- The income of preferred stock is restricted by virtue of a certain rate per cent dividend. This means two things. One, preferred stockholders ordinarily succeed in getting a specified income; and second, in the absence of profits or the availability of a dividend, preferred stock holders have to go without an income. Moreover,
preferred stockholders can never think of cutting melons in the years of corporation’s prosperity.

3. Redemption- Where preferred stock is callable, the Board of Directors can retire it at their option. This is usually done when the corporation desires to dislodge the burden of high dividend on preferred stock, and it can afford to retire the preferred stock by paying off the stockholders. Sometimes, there is a provision for the establishment of a sinking fund for the retirement of preferred stock. This is a blessing for preferred stockholders, for the corporation has thereby made a definite provision for the redemption of their stock. However, there is no gainsaying the fact that the corporation may use this weapon against the preferred stockholders by calling back and retiring the preferred stock much against their wishes, if there is a provision to that effect in the corporation’s charter.

4. There is no guarantee on returns to equity share holders. If the company makes no profit they are not entitled to receive any dividend at all.

5. Equity share holders are in a sense the risk bearers and they are acting as the financial shock absorbers of the company.

6. Undue dependence on equity capital eliminates the possibility of trading on equity to increase the return on equity shares.

3.3.4 Equity Shares with Detachable Warrant

A warrant is a contract that gives its holder the right to buy a designated number of shares of a stock at a specified price before a set date but the holders have no obligation to do so. When a warrant is exercised, the number of shares of stock outstanding will also increase accordingly with the consequent dilution of earnings. Warrants clearly indicate the number of shares entitled to the holder, the expiry date, and the price of the equity. Warrants are often attached to either a debenture or preferred stock or equity. Usually warrants may be detached from the host security to which they were attached to and then be traded separately. Equity shares with detachable warrants were introduced in the year 1992-93. These instruments are issued to only the fully paid equity shareholders. They are issued along with the fully
paid equity shares which entitle the warrant holders to apply for a specified number of shares at a predetermined price. The terms and conditions regarding the issue of equity share warrants will be decided by the company.

Section 144 of the Indian Companies Act of 1956 deals with the issue of Equity Shares with Detachable Warrant. As per Section 144, a public company limited by shares, with the prior approval of the Central Government can issue Detachable Warrants. A company issuing such an issue is authorized by its Articles of Association. A company issuing such warrants under its common seal gives a right to the holder for the entitlement of equity shares specified in the warrant and for the payment of the future dividends on the shares specified in the warrant.

A share warrant shall entitle the bearer thereof to the shares therein specified, and the shares may be transferred by delivery of the warrant. The bearer of a share warrant shall, subject to the articles of the company, be entitled to have his name entered on surrendering the warrant for cancellation and by paying such fee to the company shall be responsible for any loss incurred by any person because of the company entering in its register of members the name of a bearer of a share

3.4 Preference Securities

Preference shares are different from common stock and are often known as preferred stock. It is an intermediate class of security between equities and debts. Preference shares have a higher rating than equity share holding helps to create a division between those having an economic interest in the company and those having control over the company.

As per Section 85 of the Companies Act of 1956, “Preference share capital” means, the share capital of any company limited by shares, whether formed before or after the commencement of this Act, and which fulfils the following requirements.

3.4.1 Characteristics of Preference Shares:

Preference shares give some rights to its holders. Important characteristics of preference shares are noted below.
1. An important right of preference shareholders is the preference in the payment of dividends at fixed amount or at a fixed rate. The dividend is usually specified as a percentage of the common shares, dividend obligation to the preferred shares should be satisfied.

2. It also carries preferential right in regard to payment of capital on winding up or otherwise. It means the amount paid as preference share must be paid back to preference shareholders before anything is paid to the equity shareholders.

3. Preferred stock may or may not have a fixed liquidation value, or at par value, associated with it. This represents the amount of capital that was contributed to the corporation when the shares were first issued.

4. In the case of cumulative preference share holders their right to receive dividend gets accumulated. It means that if the dividend is not paid it accumulates year wise.

5. Some preferred shares have special voting rights to approve certain extraordinary events (such as the issuance of new shares or the approval for the acquisition of the company) or to elect directors, but most preferred shares provide no voting rights associated with them. Some preferred shares gain voting rights only when the preferred dividends are in arrears for a substantial period.

6. Usually preferred shares contain protective provisions which prevent the issuance of new preferred shares with a superior claim. Individual series of preferred shares may have a senior, pari-passu or junior relationship with other series issued by the same corporation.

In short, preference share capital has two priorities i.e. in the repayment of capital and payment of dividend. However, this right to dividend is not like any other debt obligation. This is because when a company is not making profit it is not liable to pay dividend to preference shareholders, but the company is required to pay interest to its other creditors in bankruptcy. Preferred stockholders will be paid out their assets before
common stockholders and after debt holders. When the issuer gets liquidated, they have the right to receive interest and/or a return of capital on priority than ordinary shareholders. Preference shares do not have a rigid liquidation value. The liquidation value means the amount of money which was paid to the company when he share was issued initially.

3.4.2 Merits of Preference Share Capital

- Dividends do not have to be paid in a year in which profits are poor, while this is not the case with interest payment on long-term debt (loans or debentures). Since they do not carry voting rights, preference shares avoid diluting the control of existing shareholders while an issue of equity shares would not.
- Unless they are redeemable, issuing preference shares will lower the company’s gearing. Redeemable preference shares are normally treated as debt when gearing is calculated.
- The issue of preference shares does not restrict the company’s borrowing power, at least in the sense that preference share capital is not secured against assets in the business.
- The non-payment of dividend does not give the preference shareholders the right to appoint a receiver, a right that is normally given to debenture holders.
- Preference shares can be issued without providing any collateral security.

3.4.3 Demerits of Preference Shares

1. Preference shares are not secured on the company’s assets.

2. It is not an attractive investment. The company needs to pay the fixed dividend only when there are sufficient profits.

3. The dividend yield traditionally offered on preference shares has been low and uncertain compared to the interest yields on creditor ship securities.

4. Preference shares holders have no right to participate in the management of the company.
3.4.4 Types of Preference Shares\textsuperscript{13}

Other types of preference shares are the following.

- **Puttable Preferred Stock:** A puttable preferred stock is a share where the shareholder is forced to redeem the shares under certain specific conditions.

- **Exchangeable Preferred Stock:** An exchangeable preferred stock is a type of stock which has the option of being exchanged to a different security.

- **Cumulative Convertible Preference Share:** A cumulative convertible preference share means a type of preference share where the dividend payable gets accumulated, if not paid. After a specified date, these shares will be converted into equity capital of the company.

3.4.5 Preference Shares with Warrants Attached

Preference share with warrants attached is an innovative type of preference share which was introduced in Indian market in 1992-93. It permits the holder to apply for equity shares for cash at a premium. Under this option each preference share carry certain number of warrants, entitling the holder to apply for equity shares at any time, in or more stages between the third and fifth year from the date of allotment. An amount equivalent to at least 10 percent of the prices as fixed by the company, would become payable on warrants on the date of their allotment as upfront payment on warrants. The amount would stand forfeited if the option to acquire share is not exercised.

3.5 SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 with Respect to Public Issue of Equity Shares or any Other Security Convertible into Equity Shares\textsuperscript{14}.

These are general conditions and common for Public Issues (IPOs as well as FPOs) and Rights Issues:

\textsuperscript{13} Id 125 at p.25
\textsuperscript{14} A.K. Majumdaar and Dr. G.K. Kapoor, “Taxmann’s company law and Practice, 17\textsuperscript{th} Edition, p.246.
(1) Any issuer offering specified securities through a public issue or rights issue shall satisfy the conditions as laid down in these regulations at the time of filing draft offer document with the Board (unless stated otherwise) and at the time of registering or filing the final offer document with the Registrar of Companies or Designated Stock Exchange, as the case may be.

(2) No issuer shall make a public issue or rights issue of specified securities:

(a) if the issuer, any of its promoters, promoter group or directors or persons in control of the issuer are debarred from accessing the capital market by the Board;

(b) if any of the promoters, directors or persons in control of the Issuer was or also is a promoter, director or person in control of any other company which is debarred from accessing the capital market under any order or directions made by the Board;

(c) if the issuer of convertible debt instruments is in the list of willful defaulters published by the Reserve Bank of India or it is in default of payment of interest or repayment of principal amount in respect of debt instruments issued by it to the public, if any, for a period of more than six months, unless it has made an application to one or more recognised stock exchanges for listing of specified securities on such stock exchanges and has chosen one of them as the designated stock exchange:

Provided that in case of an Initial Public Offer, the issuer shall make an application for listing of the specified securities in at least one recognized stock exchange having nationwide trading terminals:

(a) unless it has entered into an agreement with a Depository for dematerialisation of specified securities already issued or proposed to be issued;

(b) unless all existing partly paid-up equity shares of the issuer have been fully paid-up or forfeited;
(c) unless firm arrangements of finance through verifiable means rewards *seventy five percent* of the stated means of finance, excluding the amount to be raised through the proposed public issue or rights issue or through existing identifiable internal accruals, have been made.

(3) Warrants may be issued along with public issue or rights issue of specified securities subject to the following:

(a) the tenure of such warrants shall not exceed twelve months from their date of allotment in the public/rights issue;

(b) not more than one warrant shall be attached to one specified security

3.6 Issue of Share at a Premium

A company may issue securities at a premium when it is able to sell them at a price above par or above face value, for example, Rs. 100 per share at a price of Rs. 120, thereby earning a premium of Rs. 20 per share. The Companies Act, 1956 does not stipulate any conditions or restrictions regulating the issue of securities by a company at a premium. However, the Companies Act does impose conditions regarding the utilisation of the amount of premium collected on securities. *Firstly*, the premium, cannot be treated as profit and, therefore, cannot be distributed as dividend. However, the same can be capitalised and distributed in the form of bonus shares. *Secondly*, the amount of premium, whether received in cash or in kind, must be recorded in a separate account, known as the "Securities Premium A/c. *Thirdly*, the amount of securities premium is to be maintained with the same sanctity as the share capital. *Fourthly*, the securities premium amount cannot be treated as free reserves as it is in the nature of capital reserve.

According to Section 52 of Indian Companies Act, 2013 the securities premium can be utilised only for:

(a) issuing fully paid bonus shares to members;

(b) writing off the balance of the preliminary expenses of the company;
(c) writing off the commission paid or discount allowed, or expenses incurred on issue of securities or debentures of the company;
(d) providing for the premium payable on redemption of any redeemable preference shares or debentures of the company.

Unless articles of association of company permit utilization of share premium account for purpose other than mentioned in Section 52(2), company court cannot approve i.e. solution to that effect.

3.7 Issue of Shares at a Discount

If the buyer of shares is required to pay less than face value of the share, for example, Rs. 9 on a share of Rs. 10, then the share is said to be issued or sold at a discount. The issue of shares at a discount is regulated by law and Section 53 of the Companies Act, 2013 provides that, subject to certain conditions, the shares can be issued at a discount. These conditions are:

(1) the issue must be of a class of shares already issued;
(2) not less than 1 year has, at the date of issue, elapsed since the date on which the company became entitled to commence business;
(3) The issue of shares at a discount is authorised by a resolution passed by the company in general meeting and sanctioned by the Company Law Board (now Central Government);
(4) the maximum rate of discount must not exceed 10% or such higher rate as the Company Law Board (now Central Government) may permit in any special case. The Company Law Board (now Central Government) allowed the issue of shares at a discount higher than 0% since SEBI found the proposal to issue shares at a discount to be technically feasible and economically viable, a new investor having come forward to invest Rs. 17 lakhs towards the equity of the company.
(5) The share to be issued at a discount must be issued within 2 months of the sanction by the Company Law Board (now Central Government) or within such extended time as the Company Law Board (now Central Government) may allow; and
(6) offer prospectus' at the date of its issue must mention particulars of the discount allowed on the issue of shares or the exact amount of the discount as has not been written off. On default, the company and every officer of the company who is in default, shall be punishable with fine which may extend to Rs. 500.

3.8 Debt Securities

Debt instruments represent contracts whereby one party lends money to another on pre-determined terms regarding the rate of interest to be paid by the borrower to the lender, the periodicity of such interest payment and the repayment of the borrowed principal amount. Debt securities are generally issued for a fixed term and redeemable by the issuer at the end of that term. Debt securities may be protected by collateral or may be unsecured, and if they are unsecured, may be contractually “senior”. The holder of a debt security is entitled to the payment of principal and interest, together with other contractual rights under the terms of the issue. Debt securities have a priority in case of bankruptcy of the issuer.

Corporates generally issue two types of debt securities (a) debentures and (b) bonds.

3.8.1 Bonds15

Bonds are issued by public authorities, credit institutions, companies and super national institutions in the primary market. Bonds enable the issuer to finance long-term investment with external funds. A bond is a negotiable certificate which entitles the holder for repayment of the principal sum plus interest. A bond investor lends money to the issuer and in exchange, the issuer promises to reply the loan amount on a specified maturity date. Failure to pay either interest or principal on due constitutes legal default and court proceedings can be initiated to enforce the contract. Bondholders as creditors, have a prior claim over common and preferred stock holders regarding

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15 Id 125 p-8.
income and assets of the corporation for the principal and interest due to them.

The most common process of issuing bonds is through underwriting. In underwriting, one or more securities firms or banks forming a syndicate buy an entire issue of bonds from an issuer and re-sell them to investors. Government bonds are typically auctioned.

In the Indian Securities market, the term ‘bond’ denotes the debt instruments issued by the Central and State Governments and public sector organizations. The term ‘debenture’ represents the debt instruments issued by the private corporate sector.

Bonds have a fixed lifetime usually a particular number of years. But long-term bonds lasting over 30 years are rare. Some bonds have been issued with maturities of up to one hundred years and some even do not mature at all. Interest may be added to the end payment or can be paid in regular installments (known as coupons) during the tenure of the bond. Bonds may be traded in the bond market and are considered relatively safe investments when compared to equity.

Bonds and stocks are both securities, but the major difference between the two is that stock-holders are the owners of the company (i.e., they have an equity stake), whereas bond-usually have a defined term, or maturity, after which the bond is redeemed, whereas stocks may outstanding indefinitely. An exception is a consol bond, which is perpetuity (i.e., bond with no maturity). Bonds issued by commercial or industrial entities are generally called corporate bonds. Bonds issued by central or state government or other government agencies are known as government bonds. Government bonds are generally issued for medium or long term period. These bonds carry a lower rate of interest than corporate bonds and resorted to as a source of finance for governments.
3.8.2 Characteristics of Bonds

These characteristics are:

a) Bond is a credit instrument whereby a corporation obtains money from the investing public in exchange for a promise to pay the stipulated rate of interest at specified intervals, in a specific way, and to repay the principal at a set time.

b) It contains a statement of the security offered to the lender and his resources, should the corporation fail to meet all its contractual obligations to the investors.

c) A bond has legal precedence over a trust agreement which is a supplementary contract between the corporation and the trustee representing the bond-holders as a group.

d) Bond-holders have a prior claim on the receipt of interest and the repayment of the principal.

e) Interest payment due to bond-holders are fixed charges.

f) Bond-holders know that their bonds have specific maturity dates, at which time the repayment of principal is due and

3.8.3 Various Types of Bonds

3.8.3.1 Secured Bonds

Secured bonds, also known as preference bonds, have their claim against the assets pledged in priority over all the other claims with inferior or with no specific liens. Bonds may be secured by a physical property or other securities. Under a specific mortgage, debentures are sold with a lien against real property. This may be the first, second, third, or so on. Such bonds are known as "prior lien" bonds. With the consent of bond-holders, as a new mortgage is placed on a property, a lien is placed on all the other mortgages. The bonds issued under such circumstances are known as prior lien bonds. It

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is obviously difficult to get the sanction of bond-holders for prior lien bonds. The term *general* or *blanket mortgage* refers to bonds secured by a general or blanket mortgage on all corporation properties which are already subject to prior mortgages, or which may be encumbered by another lien. The term *first* and *general mortgage* means that bonds have the first lien on some of the corporation's property and a general mortgage on the rest.

(i) *Senior Lien Debentures* :- The claim of senior lien debentures against assets is superior to all the other liens. Obligations given to the priorities laid down by the court, the Government, etc., rank first. After them, the senior lien debenture-holders may enforce their claims against the assets pledged in the event of the corporation's default in the fulfillment of its promises. Senior lien bonds may be general first mortgage debentures, divisional debentures and special mortgage debentures.

(ii) *Purchase Money Bonds* :- These are bonds given in direct payment, either in part or in full, for property; and since they have a lien on such property in almost all cases, they constitute the first lien. Their important characteristic is that they must be given to sellers of property in direct payment thereof.

(iii) *Divisional Bonds* :- A corporation may issue senior lien bonds by issuing what are known as *divisional bonds*. Divisional bonds may pay the general first mortgage bonds. General first mortgage bonds of a small corporation become divisional bonds when the corporation becomes a part of a large organisation.

(iv) *Junior Lien bonds* :- Junior lien bonds are secured by a physical property, for as their very name suggests, they have their claims next to those of the senior bonds. It would not be correct to say that all the junior lien bonds have an inferior investment status. The investment status depends upon the proportion of the issue of the bonds to the senior lien bonds.

(v) *Combination Lien Bonds* :- Some bonds are a combination of senior and junior liens. The common names of such issues are *first and refunding* or *first
and general, etc. They have their first claim against some specific property and a junior claim against other property.

(vi) **Collateral Trust Bonds** :- A corporation may issue bonds which are secured by other securities. They may be collateral trust bonds and secured by short-term notes. Many corporations, owning securities of other corporations, use them as collaterals for loans, particularly for short-term loans. Thus, collateral trust bonds are mortgage bonds with securities as the basis of the issue. They were popular in railroad public utilities and industrial organisations.

(vii) **Subordinate Bonds** :- Subordinate debentures are debenture bonds which, by contract, allow other senior debt a prior claim against the earnings and assets of the company. What constitutes a senior debt is clearly defined in each subordinate issue.

(viii) **Closed Issues** :- When a trust deed is authorised to issue a certain number of bonds, the issue of bonds is said to be closed. When the corporation disposes of that amount, no more debentures with the same claim can be issued against that property. This issue restricts the borrower from pledging the same asset for another loan. In other words, no ne

### 3.8.3.2 Unsecured Bonds

Unsecured bonds, also called plain or *simple* bonds, are those which have no lien upon specific property or stocks and securities. They should not, however, be taken as insecure bonds. It should be remembered that the trust deed always takes care of the security of bonds, whether secured or unsecured. But they do not carry any definite pledge on specific property to protect the debt. That is why they are known as "unsecured."

A corporation may prefer to raise unsecured debts for several reasons:

(i) It may be in a strong financial position and need not offer any lien on its properties;

(ii) It may not have any property which is free for mortgage purposes;
(iii) It may like to be free from the restrictions arising out of a mortgage;

(iv) It may have such assets as cannot be mortgaged; and

(v) The condition of stock exchange may be favourable for the issue of such bonds. Unsecured bonds can be classified as under:

(A) On the Basis of Obligatory Promises:

(i) Debentures;

(ii) Joint Bonds;

(iii) Receivers' Certificates;

(iv) Assumed Bonds; and

(v) Guaranteed Bonds.

(B) On the basis of contingent promises:

(i) Income or Adjustment Bonds;

(ii) Participating Bonds;

(iii) Revenue Bonds;

(iv) General Obligation Bonds; and

(v) Trust Certificates.

(A) On the Basis of Obligatory Promises

Corporations must meet the terms of the bonds, failing which they are considered to be in default.

(i) Debentures :- A debenture is a plain bond. Debentures are inferior in status in the sense that they do not carry the right of foreclosure or a right in the precipitation of receivership and reorganisation of a corporation. They are not rated as high as mortgage bonds, and always viewed with suspicion by investors. Moreover, they have a shorter duration than that of mortgage bonds. However, debentures get the
maximum attention of the trustees who restrict the further issue of
debentures, and open market borrowings, and require corporations to
maintain a satisfactory current ratio, that is, the ratio of current assets
to current liabilities.

(ii) **Joint Bonds** :- A joint bond is a hybrid security. A corporation offers a
specific property in pledge and gives the bond-holders a guarantee as
regards the payment of the principal and interest. Several corporations
cooperate in using a jointly-owned, separate corporation to build and
operate the facility which they need. A separate corporation may issue
joint bonds to finance a new facility. Joint bonds receive joint and
several guarantees from all the corporations holding an interest in the
facility.

(iii) **Receivers' Certificates** :- When a corporation fails, its control passes into
the bands of the court, its agent and the receiver. Court authorities issue
the receivers' certificates, payment of which is secured by the property
and credit of the corporation. The court declares a *moratorium* on all
the debts in default and gives the receivers' certificates for them. These
certificates are an obligation on the part of the court and not of the
corporation.

(iv) **Assumed Bonds** :- An assumed bond is another hybrid security. It is a
mortgage bond issued by the corporation which is subsequently
absorbed by another corporation. The mortgaging corporation declares
that it will assume the obligations of the bond-holders of the merged
corporation. An assumed bond gets double protection—one of specific
property originally pledged and, the other, of the general credit assured
by the merging corporation.

(v) **Guaranteed Bonds** :- These are mortgage bonds which acquire the
additional protection of the general credit granted by another
corporation in the form of endowment or by way of a separate contract
filed with the trustee. The investment status of guaranteed bonds
depends upon the earning power of the issuing corporation, the
liquidation value of the assets securing the bond issue, the nature of the guarantee and the ability of the guarantor to live up to the contract.

3.8.3.3 On the Basis of Contingent Promises

(i) Income Bonds :- Income bonds are secured as to the payment of the principal but depend for their income upon earnings and the desire of the Board of Directors of the issuing corporation to distribute earnings as dividend. Though they are known as income bonds, they inherit a great uncertainty of income and, for the same reason, are sometimes referred to as guinea pigs. They are obviously a hybrid security. Income bonds are usually offered to mortgage bondholders in exchange for their holdings and those who have no other alternative but to accept the income bonds.

(ii) Participating Bonds :- Participating bonds are hybrid securities. They hold mortgage protection and are entitled to regular interest as fixed income. They are entitled to share in the excess earning of the corporation, if any. Certain income bonds have been made participating bonds. The participating provision of this kind serves to prevent the practice of accumulating profits for several years and then paying only one year's interest on income bonds, together with a sizeable dividend to stockholders.

(iii) Revenue Bonds :- These are issued by the Government. Interest on these bonds is paid out of the revenue generated from the specific project financed by the bonds.

(iv) General Obligation Bonds :- These are backed by the general taxing power of local self-organisations.

(v) Trust Certificates :- Trust certificates are neither bonds nor stocks and are commonly used to finance railroad equipment, real estate projects and so on. Trust certificates are of different types.

3.8.3.4 Bearer Bonds

Bearer bonds, also known as coupon bonds, have a series of post-dated service coupons attached to them which are payable to the bearer for interest
over the life of the bond. At maturity, the coupon bond must be presented for
redemption to the corporation or trustee. Such bonds are highly negotiable
and must be treated like cash. Coupon bonds are not registered and can be
transferred by passage.

3.8.3.5 Registered Bonds

Registered bonds are dealt with like stocks, and payments of interest
and notices of changes, calls, etc., are sent to registered owners. Most of the
registered bonds are registered as to principal and interest. However, some
bonds may be registered as to principal only and may have attached coupons
like bearer or coupon bonds for the purpose of interest payment. A registered
bond contains the name of the bond-holder. The interest on the bond is paid
directly to the holder. If a holder wants to transfer a bond, he must endorse it.

3.8.3.6 Serial Bonds

The corporation issues bonds in series in which one series matures in
one year and another in another year. The advantage of issuing serial bonds is
that all of them do not fall due for payment at the same time, and they do not
cause financial embarrassment to the corporation.

3.8.3.7 Bonds with Warrants

A warrant is the privilege of purchasing a firm's common stock at some
specified price, called the option price which is above the current price of the
common stock. It is similar to a convertible bond.

3.8.3.8 Funding or Refunding Bonds

The bonds that are issued to consolidate an unfunded debt are
sometimes known as funding bonds; for, the purpose is to fund all or a part of
the corporation's unfunded debt. The bonds that are issued to obtain funds to
pay off the existing funded debt are called refunding bonds.

3.8.3.9 Endorsed Bonds

In some cases, a corporation may simply endorse the bonds of another
corporation, thereby implying a guarantee of payment. Such bonds are called
Endorsed Bonds.
3.8.3.10 Stamped Bonds

Sometimes, additions or modifications to the original indenture is made by the issuing company or by the second company. These addenda may be stamped on the bond surface, which may then be called *stamped bonds*.

3.8.3.11 Extended Bonds

Extended bonds are matured bonds which by agreement between the bond-holder and the corporation have their maturity dates extended for a number of years. In this process, the rate of interest may be increased or decreased, as the case may De.

3.8.3.12 Split-Coupon Bonds

A split-coupon bond is one which carries a fixed rate of interest in addition to the interest contingent on earnings. These bonds are usually issued at the time of corporate reorganisation or debt readjustment.

3.8.3.13 Perpetual Bonds

Some bonds may be perpetual in the limited sense that the issuing corporation is under no obligation to redeem them at any time; but it has a right to call them for redemption at a specified time and at a specified price.

3.8.3.14 Consolidated Bonds

These are bonus issued for the purpose of consolidating a number of separate bond issues into one—an opportunity often taken to increase the amount of the total issue and to adjust the interest rate. The holders of new bonds benefit by having a broader security and a freer market.

3.8.3.15 Convertible Bonds

Corporations encourage the purchase of their bonds by adding *bond sweeteners* to them. This is usually done during periods of credit stringency. A sweetener is a financial benefit in addition to the interest. There are two sweeteners which are presently used. Convertible bonds are exchangeable. At any point, bond-holders have the option to go in for the common stock of the
issuing corporation. At their option, they may exchange their bonds for a specified number of shares of common stock or preferred stock or other types of bonds. Most of the convertible bonds have been issued by industrial corporations to facilitate the sale of bonds at a lower rate of interest while looking forward to the possibility that the funded debt and fixed charges will be extinguished by conversion, if the corporation so desires.

3.8.3.16 Callable or Redeemable Bonds

A call or redemption feature enables the corporation to pay off bonds before their maturity or refund bonds by issuing other securities.

3.8.3.17 Sinking Fund Bonds

The sinking fund bonds cast upon the corporation an obligation to set aside a certain sum from its earnings periodically for the purpose of reducing bonded indebtedness.

3.9 Debenture

The definition of 'debenture' as contained in Section 2(30) of the Companies Act, 2013 does not explain the term It reads, "Debenture includes debenture-stock, bonds and any other securities of a company whether constituting a charge on the company's assets or not". The nature of debenture is thus not described by this definition.

The term 'debenture' is not a technical term, Lindley J. in British India, etc. Co, v. IRC [1881]7 QBD 165 has said:

“……..What the correct meaning of debenture is I do not know. I do not find anywhere any precise definition of it. We know that there are various kinds of instruments commonly called debentures. You may have mortgage debentures, which are charges of some kind on property. You may have debentures which are bonds;.. . .You may have a debenture which is nothing more than an acknowledgement of indebtedness. And you may have a thing like this, which is something more; it is a statement by two directors that the company will pay a certain sum of money on a given day, and will also pay
interest half-yearly at certain times and at a certain place, upon production of certain coupons by the holder of the instrument."

Thus, the term 'debenture' simply means a document acknowledging a loan made to the company and providing for the payment of interest on the sum borrowed until the debenture is redeemed, *i.e.*, the repayment of the principal sum. It may or may not be under seal and so does not necessarily imply that any charge is given on the company's assets, though such a charge usually exists.

The meaning of the term 'debenture' is thus very wide, it would go too far to assert that every document creating or acknowledging an indebtedness of the company is a debenture, commercial men and lawyers would certainly not use this term when referring to bills of exchange or other negotiable instruments, deeds of covenant and many other documents in which a company stipulates to pay a sum of money

### 3.9.1 Characteristic of a Debenture

The characteristic features of a debenture are as follows:

- It is a movable property.
- It is issued by the company and is in the form of a certificate of indebtedness.
- It usually specifies the date of redemption. It also provides for the repayment of principal and interest at specified dates.
- It generally creates a charge on the undertaking or undertakings of the company.

Usually the words *'pari passu'* appear in the terms and conditions of debentures. This means that all the debentures of a particular class will receive the money proportion in case the company is unable, to discharge the whole obligation. In the absence of this clause the debenture-holders would rank in accordance with the rank of the issue and if issued on the same date then in the order of time when they were issued (which is known by the serial number of the debenture).
3.9.2 Debenture Stock

A company, instead of issuing individual debentures, evidencing separate and distinct debts, may create one loan fund known as "debenture-stock" divisible among a class of lenders each of whom is given a debenture-stock certificate evidencing the parts of the whole loan to which he is entitled; This debenture-stock, which is analogous to the loan stocks of Governments and local and public authorities, is then the indebtedness itself, and the certificate evidences the stockholder's interest in it. A consequence of the distinction is that whereas a debenture is a single thing which can be legally transferred only as one entity, debenture-stock can be sub-divided and transferred in any fractions which the holder wishes. One more distinction between the two 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'.

3.9.3 Difference between Shareholder and Debenture Holder

The points of distinction between share and debenture may be noted as follows:

1. A shareholder is a member of the company. A debenture holder is a lender to the company.
2. A shareholder has a right to vote. A debenture holder does not enjoy such a right. Section 117 declares that no company shall after the commencement of the Companies Act, 1956 issue any debentures carrying voting rights at any meeting of the company.
3. 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.
4. Shareholders cannot be paid back (except in case of redeemable preference shares) until its winding-up. Debenture holders, unless the
debentures are irredeemable, may be paid back on the expiry of the specified time.

5. 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.

6. 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. The power to issue debentures rests with the Board of directors (section 292). Debentures may be issued at par, at a premium or at a discount,* * unless the Articles specifically forbid issue of debentures at a discount.

3.9.4 Advantages of Debentures

Some of the advantages of debentures have been outlined here:

(i) A debenture is an important instrument of long-term debt financing. It is difficult to support the growth rate of the company's sales and assets entirely with retained earnings. The corporation has, therefore, to resort to debenture financing in order to acquire additional assets. An increase in debt may bring a desirable increase in the rate of earnings. As long as financial leverage works favourably, the company uses debt financing to increase the return for shareholders;

(ii) Businessmen use debt financing rather than equity financing on the assumption that, with an increase in sales revenue, they would be able to meet their interest obligations without difficulty;

(iii) Investors often refuse to buy new shares of financially weak or low profit corporations »x any price;

(iv) Inflation enables a corporation to use more and more long-term debt;
(v) It is cheaper than equity capital, and it reduces a firm's cost of capital;

(vi) It provides a degree of flexibility which may improve a firm's rate of return on investment;

(vii) It may be the only resource available, regardless of cost;

(viii) Interest payments on debentures are legitimate deductible expenses, but dividends paid to stockholders are not;

(ix) If all the terms of indenture are met, there is nothing that the debenture-holders can do to interfere with the operations of the company. In the ordinary course of affairs, they do not have any voice in the running of the concern. A corporation enjoys leverage which permits stockholders to cash in on the investments made with the use of borrowed funds as long as the return exceeds interest payments; (x) Firms whose earnings are reasonably stable can afford to use debt financing. Public utilities, for example, can use debentures with advantage. However, industrial firms whose earnings are highly volatile cannot afford the luxury of financial leverage;

(xi) Debt financing is recommended for firms with assets which would serve as security for long-term credit. Debt financing may be undertaken by those financial institutions which are severely limited or completely prohibited from providing equity funds. Such institutions as a source of funds use debt for their capital structure;

(xii) Institutions created or sponsored by the Government for aiding small business have to use only debentures;

(xiii) Many small and middle-sized firms employ debentures in order to maintain control;

(xiv) **No Sharing of Control**: Creditors have no voice in business operations. The owners may extend the scope of their operations by using the funds furnished by creditors, and still maintain their position of control. The raising of additional funds by bringing more owners
into the business usually involves the sharing of control with the new owners and if the proportion of the new capital raised in this manner is large, it might eventually result in loss of control;

(xv) Low Cost :- It has been pointed out that because of the precedence given to creditors in claims to the income and assets of the company in dissolution, they generally accept a relatively low and fixed income as compared with that expected by the owners. If additional funds can be used profitably in business, and if the owners have a choice of the sources of those funds as between creditors and owners, the funds can be obtained at a lower cost from the former class;

(xvi) Only Funds Available :- In many cases, particularly for small enterprises, debenture funds may be the only source of additional available funds;

(xvii) Flexibility :- Many enterprises, because of the seasonal nature of their business, have temporary need for additional funds to carry heavier inventories or accounts receivables. When this happens, it is generally more advantageous for the firm to obtain additional funds from creditors than owners.

(xviii) Debentures are convenient because they pledge only the general credit of the company. In other words, the debenture-holder becomes a general creditor of the corporation with a priority equal to that of other general creditors having claims against the unpledged assets of company.

(xix) Debentures have usually a short-term maturity than mortgage bonds;

(xx) The debenture-holder does not disturb the voting position of existing shareholders;

(xxi) The use of debt capital increases the earnings on equity capital;

(xxii) The financial condition of the corporation may not be satisfactory. It may not, therefore, attract new stock issue. The retained earnings may
be insufficient to provide funds whereas the conditions of the market stock may be poor;

(xxiii) Debentures are most often used by corporations with a strong credit standing, but which neither afford nor desire to pledge mortgage assets;

(xxiv) Debentures are issued by important industrial corporations which prefer to keep their short-term general unsecured credit position strong and may be reluctant to offer prior claims on their assets;

(xxv) Corporations whose credit rating in the market is very high and which can offer securities without any mortgage are in a position to issue debentures; and

(xxvi) Corporations which have mortgaged all their available assets have no option but to issue debentures in order to collect funds. Obviously, they are required to pay a high rate of interest to compensate for the risk.

3.9.5 Disadvantages of Debentures

The disadvantages of debentures are:

(i) Capital involving higher cost on issue of debentures, which earlier produced low cost funds, require to be repaid;

(ii) Debt has to be related to risk, which is difficult to predict;

(iii) The use of debentures increases the possibility of insolvency and results in variations in the earnings available to equity;

(iv) Leverage can also work the other way. If a company's income is not sufficient to meet its interest expense, stockholders will obviously be in a worse shape because of the company's indebtedness. Debt interest on debentures must be met. This is one of the prime obligations of corporations. Interest payments on debentures are fixed charges which must be paid, come what may;
(v) There is a specific maturity date for debentures, which means that corporations have to establish a programme of amortization, looking towards eventual refunding or repayment of debt;

(vi) Another area that might prove disadvantageous is indenture! Business conditions are always changing. As a result, indenture terms, which seemed reasonable at one point of time, may prove to be burdensome as years pass. Often a company finds itself unduly encumbered by covenants. Continuous financing of this nature has the effect of raising the borrowing costs as well as making equity financing more expensive.

(vii) The primary disadvantage of the use of debentures is the risk to the owners' investment, which flows from the inability of the company to meet the creditors' claims when they are due. The danger is two-fold. A more difficult problem is that of meeting the payment of the principal at maturity, and the other less relatively difficult problem because of smaller sums involved is that of meeting periodic interest payments;

(viii) The position of debenture-holders, is likely to be damaged by additional debt agreements entered into by the corporation. Debentures are, therefore, provided with a number of protective provisions:

(a) Additional funded debt is prohibited unless the specified ratio between net tangible assets and funded debt is maintained;

(b) Dividend payments on equity stock are prohibited, if current assets decline below a specified proportion of current liabilities and if the surplus falls below a specified amount;

(c) The issue of additional debentures is prohibited;

(d) It is sometimes provided that, if any mortgage bonds are issued subsequently, debentures will be given equal security with these bonds; and
(e) The provision of sinking fund is usually insisted upon in the case of debenture issue.

A borrowing that is judicious, purposeful and not excessive can be very fruitful. It gives stockholders a leverage or enables them to trade in the equity. The amount of long-term borrowing in which a concern is willing to engage depends primarily on the philosophy of its management. Some managements are venturesome, in which case they do not hesitate to use an unusually large ratio of borrowed capital to their total capitalisation. Others borrow because they have little choice. The price of their stock may be so low that a public offering would be destined to be unsuccessful. Borrowing may thus present the only reasonable alternative.

3.9.6 Types of Debentures –

Debentures may be of the following Kinds

(i) *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.

(ii) *Registered debentures* - These are debentures which are payable to the registered holders, *i.e.*, persons whose names appear in the Register of debenture holders. Such debentures are transferable in the 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.

(iii) 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. As a general rule, says Oliver, MLC, "when a mortgage is made by an individual, equity will not permit it to be irredeemable. The purpose of the transaction has been to borrow money; anything, therefore, which prevents the borrower from repaying the loan and recovering his security will be void in equity. This will be the position right up to the moment when the mortgagee has obtained an order for the sale or foreclosure of the mortgaged property, even if the legal or contractual right to redeem has long since expired. Equity expresses this rule in the maxim: "Once a mortgage always a mortgage"

Thus, the mortgagor normally has a legal or contractual right to repay the loan and redeem his property on the date specified in the contract of loan. If this date has passed, he has an equitable right to redeem his property on payment of the loan and accrued interest.

The above rule is, however, subject to an exception in the case of companies. Section 120 expressly states that a condition contained in any debenture is not invalid by reason only that thereby, the debentures are made irredeemable or redeemable only on the happening of a contingency, however remote, or on the expiration of a period, however long. It follows that debentures can be made perpetual, i.e., the loan is repayable only on winding-up, 01 after a long period of time.

(iv) Redeemable debentures - Redeemable debentures are issued for a specified period of time. On the expiry of that specified time the company has the right to pay back the debenture-holders and have its properties released from the mortgage or charge. Generally, debentures are redeemable.
Re-issue of redeemed debentures - Redeemed debentures can be re-issued. Section 121 provides that if there is no provision to the contrary in the articles, or in the conditions of the issue, or if there is no resolution showing an intention to cancel the redeemed debentures, the company shall have power to keep the debentures alive for the purpose of reissue. The company may reissue either the same debentures or other debentures in their place. Upon such reissue the person entitled to the debentures shall have the same rights and priorities as if the debentures had never been redeemed.

Notice that, where with the object of keeping debentures alive for the purpose of re-issue, they have been transferred to a nominee of the company, a transfer from that nominee shall be deemed to be a re-issue.

(v) 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.

(vi) Convertible- debenture :- A company may also issue Convertible debentures, in which case an option is giver, to the debenture-holders to "convert them into equity or preference shares at started rates of exchange, after a certain period. Such debenture,-` once converted into shares cannot be reconverted into debentures.

According to convertibility, debentures are further classified into three categories:17;

1. Fully Convertible Debentures (FCDs)
2. Non-Convertible Debentures (NCDs)
3. Partly Convertible Debentures (PCDs).

Fully convertible debentures :-Fully convertible debentures are those debentures that are converted into equity shares of the company on the expiry

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17www.vakilno1.com visited on 16th June 2012.
of specified period of periods. Where the conversion is to be made at or after 18 months from the date of allotment but before 36 months, the conversion is optional on the part of the debenture-holders in terms of SEBI guidelines.

**Non-convertible debenture:** Non-convertible debentures are those debentures that do not confer an 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:** Partly convertible debenture consists of two parts, viz., convertible and non-convertible. The convertible part(s) is/are convertible into equity shares at the expiry of specified period(s). Non-convertible part, on the other hand, is redeemed at the expiry of a certain period(s). Where the conversion takes place at or after 18 months, as per SEBI guidelines, the conversion is optional at the discretion of the debenture-holder.

**Features of convertible debentures:** The main features of convertible debenture may be noted as follows:

1. The debentures are converted into specified or unspecified number of equity shares at the end of a specified period. The ratio at which the convertible debentures are exchanged for equity shares is known as conversion price or conversion ratio. Conversion ratio is worked out by dividing the face value of a convertible debenture by its conversion price. For example, if the face value of the convertible debenture is Rs. 100 and it is convertible into two equity shares of Rs. 10 each, the conversion price is Rs. 50 and the conversion ratio is 2. Since the difference between the conversion price and the face value of the equity share is Rs. 40, the conversion premium per share is Rs. 40.

2. Convertible debentures may be fully or partly convertible. In case of fully convertible debentures, the entire face value is converted into equity shares at the expiry of certain period(s).

   In case of partly convertible debentures, the convertible portion is converted into equity shares at the expiry of certain period(s), and the non-convertible portion is redeemed at the expiry of certain period.
3. Convertible debentures, whether fully or partly convertible, may be converted into equity shares at the end of specified period or periods in one or more stages. In terms of SEBI Regulations, fully convertible debentures, with a conversion period of more than 36 months can be issued only with put and call option. If the conversion is at or after 18 months, but within 36 months, conversion will be at the option of the debenture-holder; otherwise, conversion is compulsory. The premium amount, if any, should be determine at the outset and the lower and the upper limits of premium should be stated in the document.

4. If one or more parts of debentures are convertible after 18 months, the company should get a credit rating of debentures done by a credit rating agency.

5. Interest on debentures may be paid as per the market forces. With effect from 1 -8 1991 interest rates on debentures have been de-regulated and companies are permitted to pay any interest they consider reasonable. Debentures can also be issued as zero interest debentures where no interest is payable on the debentures.

6. Convertible debentures are listed on the stock exchanges. However, in practice, convertible debentures are not actively traded in the stock exchanges in India excepting those of reputed companies.

*Debentures Redemption Reserve (DRR) (Section 117C) - In respect of debentures issued after the commencement of the Amendment Act, 2000 the company is required to create a debenture redemption reserve for the redemption of such debentures.*

The company shall credit the DRR adequate amounts from out of its profits every year until such debentures are redeemed. For housing finance companies registered with the National Housing Bank under Housing Finance Companies (NHB) Directions. 200!, the adequacy of DRR will be 50% of the value of debentures issued through public issues and no DRR is required in the case of privately placed debentures [Deptt.’s Circular dated 16-1 -2003]
**DRR shall be utilised by the company only for the purpose of redemption, of debentures** - The company shall pay interest and redeem the debentures in accordance with the terms and conditions of their issue.

**Failure to redeem the debentures** - If a company fails to redeem the debentures on the due dates, any or all the debenture-holders can make an application to CLB (now Tribunal). CLB (now Tribunal), after hearing the parties concerned, may direct, by order, the company to redeem the debentures forthwith by payment of principal and interest due thereon.

**Penalty for non-compliance** - Every officer of the company who is in default shall be punishable with imprisonment which may extend to three years and shall also be liable to fine which shall not be less than rupees five hundred for every day during which the default continues.

### 3.9.7 Rights/Remedies of Debenture-Holders

In case of default by the company in repayment, the remedies of a debenture-holder vary according to whether he is secured or unsecured.

An unsecured debenture-holder is in exactly the same position as a creditor and he has the same remedies. Thus, (1) he may sue for the principal and interest, or (2) he may present a petition for the winding up of the company and prove his debt as unsecured.

A secured debenture holder has both the above remedies, but in addition he has the following courses also open to him:

(i) **Where a trust deed has been executed:**

1. **Sale of Assets** - The power of sale by trustees is one of the express powers usually contained in the debenture or debenture trust deed. If no such power is given, an application may be made to the Court for an order to sell.

2. **Foreclosure** - The trustees may make an application to the Court for an order of foreclosure, the effect of which is that the borrowers' interest in the assets charged is completely extinguished and the lender
becomes the owner of them. For an action of foreclosure, it is necessary that all debenture-holders of the class concerned join hands.

3. **Appointment of a Receiver** - Where there is a trust deed, it often provides that the trustees may appoint a Receiver. If no such power is given, application to appoint one may be made to the Court in a debenture holders' action. On the appointment of a Receiver, the assets become specifically charged in favour of the debenture-holders, and the power of the company to deal with them in the ordinary course of business ceases, although the company continues to exist until it is wound-up.

(ii) **Where no deed has been executed:**

**Debenture holders' action**\(^{18}\): Where no trust deed has been executed in favour of debenture-holders, a debenture holder may, on default in payment of principal or interest, bring an action (called a debenture holders' action) on behalf of himself and other debenture holders of the same class asking for:

(i) a declaration that the debentures have a charge on the assets;

(ii) an account of what is owed to the debenture holders: the amount of assets; prior claims, etc.;

(iii) an order of foreclosure or sale;

(iv) the appointment of a Receiver.

If a debenture holder owes a debt to the company which is insolvent, the holder cannot set off his debt against the liability he owes to the company. The rule is that a person who claims a share in a fund must first pay up every thing he owes to the fund before he can claim a share\(^ {19}\)

### 3.10 SEBI Regulations, 2009 Pertaining to Convertible Debt Instruments\(^ {20}\)

In addition to the requirements laid down in SEBI K emulations, 2009 relating to Issue of Capital and Disclosure Requirements an issuer making a

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\(^{18}\) Ibid.

\(^{19}\) Re Brown and Gregory Ltd. [1904] 1 Ch. 627.

\(^{20}\) [www.sebi.com](http://www.sebi.com), Visited on 26\(^{th}\) April 2011.
public issue or rights issue of Capital and Disclosure Requirements an issuer making a public issue or rights issue of convertible debt instruments must comply with the following conditions:

(a) it has obtained credit rating from one or more credit rating agencies;

(b) it has appointed one or more debenture trustees in accordance with the provisions of section 117B of the Companies Act, 1956 and Securities and Exchange Board of India (Debenture Trustees) Regulations, 1993

(c) it has created debenture redemption reserve in accordance with the provisions of section 117C of the Companies Act, 1956;

(d) if the issuer proposes to create a charge or security on its assets in respect of secured convertible debt instruments, it shall ensure that:

(i) such assets are sufficient to discharge the principal amount at all times;

(ii) such assets are free from any encumbrance;

(iii) where security is already created on such assets in favour of financial institutions or banks or the issue of convertible debt instruments is proposed to be secured by creation of security on a leasehold land, the consent of such financial institution, bank or lesser for a second or pari passu charge has been obtained and submitted to the debenture trustee before the opening of the issue;

(iv) the security/asset cover shall be arrived at after reduction of the liabilities having a first/prior charge, in case the convertible debt instruments are secured by a second or subsequent charge.

(2) The issuer shall redeem the convertible debt instruments in terms of the offer document.

Roll Over of non-convertible portion of partly convertible debt instruments -

(1) The non-convertible portion of partly convertible debt instruments issued by a listed issuer, the value of which exceeds fifty lakh rupees, may be rolled over without change in the interest rate, subject to compliance with the...
provisions of section 121 of the Companies Act, 1956 and the following conditions:

(a) seventy five per cent of the holders of the convertible debt instruments of the issuer have, through a resolution, approved the rollover through postal ballot;

(b) the issuer has, along with the notice for passing the resolution, sent to all holders of the convertible debt instruments, an auditors' certificate on the cash flow of the issuer and with comments on the liquidity position of the issuer;

(c) the issuer has undertaken to redeem the non-convertible portion of the partly convertible debt instruments of all the holders of the convertible debt instruments who have not agreed to the resolution.

(d) credit rating has been obtained from at least one credit rating agency-registered with the Board within a period of six months prior to the due date of redemption and has been communicated to the holders of the convertible debt instruments, before the roll over;

(e) The creation of fresh security and execution of fresh trust deed shall not be mandatory if the existing trust deed or the security documents provide for continuance of the security till redemption of secured convertible debt instruments:

Provided that whether the issuer is required to create fresh security and to execute fresh trust deed or not shall be decided by the debenture trustee.

*Conversion of Optionally Convertible Law instruments into Equity Share Capital* - (1) An issuer shall not convert its optionally convertible debt instruments into equity shares unless the holders of such convertible debt instruments have sent their positive consent to the issuer and non-receipt of reply to any notice sent by the issuer for this purpose shall not be construed as consent for conversion of any convertible debt instruments.

Where the value of the convertible portion of any convertible debt instruments issued by a listed issuer exceeds fifty lakh rupees and the issuer has not determined the conversion price of such convertible debt instruments
at the time of making the issue, the holders of such convertible debt instruments shall be given the option of not converting the convertible portion into equity shares:

Provided that where the upper limit on the price of such convertible debt instruments and justification thereon is determined and disclosed to the investors at the time of making the issue, it shall not be necessary to give such option to the holders of the convertible debt instruments for converting the convertible portion into equity share capital within the said upper limit.

Where an option is to be given to the holders of the convertible debt instruments in terms of sub-regulation (2) and if one or more of such holders do not exercise the option to convert the instruments into equity share capital at a price determined in the general meeting of the shareholders, the issuer shall redeem that part of the instruments within one month from the last date by which option is to be exercised, at a price which shall not be less than its face value.

The provision of sub-regulation shall not apply if such redemption is in terms of the disclosures made in the offer document.

Issue of Convertible Debt Instruments for Financing - No issuer shall issue convertible debt instruments for financing replenishment of funds or for providing loan to or for acquiring shares of any person who is part of the same group or who is under the same management:

Provided that an issuer may issue fully convertible debt instruments for these purposes if the period of conversion of such debt instruments is less than eighteen months from the date of issue of such debt instruments.

New financial instruments :- Zero coupon debentures /bonds - Zero coupon bonds are those bonds that are sold at a large discount on the nominal value. The maturity period of these bonds vary from 5 to 12 years. On maturity, the debenture is redeemed at par value.
In India, zero interest convertible bonds have also been issued by companies. Since the investor is not entitled to any interest on the bonds, the conversion price is suitably adjusted to take care of the interest loss of the investor. These bonds were first issued in India by Mahindra and Mahindra Ltd.

*Advantages to the company* - The main advantage to the company is that there is no burden of servicing the debentures during the gestation period of the project. By linking the redemption/conversion period with the commissioning of the project, the company can ensure that there are considerable savings in project cost and there is no-cash outflow for servicing of the debentures during the implementation stage of the project.

*Advantages to the investors* - The interest being only notional is not subject to tax. However, on sale or disposal it would attract capital gains tax.

Zero coupon bonds are attractive to investors particularly during periods when interest rates are declining.

### 3.11 Warrants

A warrant confers an option to the investor to buy a specified number\(^1\) of equity shares at a specified price over a specified period of time. The warrant holder has to surrender the warrant and pay some cash known as the exercise price of the warrant to purchase the shares. On exercise of the option, the warrant holder becomes the shareholder. A number of companies in India have issued such warrants. Presently, SEBI guidelines, in this regard, require 10 percent of the price to be payable at the time of allotment of warrants and compulsory conversion of Warrants into shares within a period of 18 months. For detailed SEBI guidelines in this regard, refer to discussion entitled SEBI Guidelines for Preferential Allotments’— Chapter 9.

*Detachables warrants* - These warrants are issued with debentures - convertible or non-Convertible – or with equity and are immediately detachable. The detached warrants can be traded in the secondary market as separate instruments.
**Puttable warrants** - These warrants confer a right on the investor to sell the warrant back to the company at a fixed price before the expiry of a fixed period.

**Wedding warrants** - These warrants are attached to the host debentures and can be exercised only if the host debenture is surrendered.

**Deep discount bonds** - These bonds are sold at a large discount on their nominal value and mature at par value. There are no interest payments on these bonds and the investors obtain their return as accretion to the par value of the instrument over its life. The maturity period of this bond can extend as far as 25 years with an option to the investors to withdraw at the end of a certain period, say 3 years or 5 years from the date of allotment IDBI in January 1992 and again in Feb.-March 1996 (Rs. 5,300 to be Rs. 2,00,000 at the end of 25 years) issued such bonds as an unsecured instrument.

**PCD/NCD with buy-back arrangements** - PCD/NCD may be offered to the investors along with a facility to buy back the non-convertible order of the debentures (khokha) by a financial institution/bank/financial services company at a discount on the face value.

As per SEBI Regulations, buy back of ‘khokha' has to be made on spot deliver; basis and procedure to their buy-back and their tradability should be disclosed in the offer document.

**Secured Premium Note (SPN):** SPN is a new kind of instrument which was issued by the TISCO Ltd. to its shareholders in June 1992. The salient feature of the instruments are:

(i) The SPN is issued at a nominal value and does not carry any interest.

(ii) The SPN is redeemed by repayment in several instalments at a premium over its face value. The premium amount is distributed equally over the period of maturity of the instalment.

(iii) The SPN may carry a detachable warrant which will give the holder a right to claim allotment of certain share or shares for cash at a certain price.
This right can be exercised by the holder after a certain period from the date of allotment of SPN.

(iv) The instrument is secured by a mortgage of all the immovable properties of the company.

**Zero coupon convertible notes** - These are debts convertible into equity shares of the issuer if investors choose to convert, they forego all the accrued and unpaid interest. These convertibles are generally issued with put option (*i.e.*, buy-back arrangement) to the investor. The investor gains in the event of appreciation in the value of the equity shares. Even if the appreciation does not materialize, the investor has the benefit of a steady stream of implied interest income.

### 3.12 Charge

The debt owed by a person to another may be either unsecured or secured. In the former case, if the debtor defaults, the creditor can sue for amount owned. If the debtor becomes insolvent or disappears, the creditor has no security. A wise creditor therefore will demand security, *i.e.* a right over the debtors property which is in addition to his right of action. A bank draft, for instance, is often secured by a deposit of the title deeds of the borrowers house (mortgage), or of his share certificate (pledge). A company like any other person can, when it borrows money give its creditors security. often it mortgages or charges its property to its debenture holders.

#### 3.12.1 Fixed and Floating Charges

The power of a company to borrow includes the power to create a charge upon its assets. The charge includes a ‘mortgage’ also. The charge that may be created on the assets of a company may be *fixed charge* or a *floating charge*.

1. **Fixed Charge**

A fixed or specific charge is one which is created on some specific and definite assets of the company For example a charge on land and building. It

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22 Section 124 of The companies Act, 1956
precludes the company from dealing in the property without the consent of the holder of the charge. The company can, if it wants to deal in that property, do so subject to the charge.

2. Floating Charge

A floating charge is an equitable charge which is created on some class of property which is constantly changing, e.g., a charge on stock-in-trade, trade debtors, etc. The company can deal in such property in the normal course of its business until the charge becomes fixed on the happening of an event. The main idea behind a floating charge is to allow the company to carry on its business in the ordinary course as if no charge had been created.

Debentures usually create a floating charge on the assets of a company.

A floating charge is an equitable charge which does not fasten on any specific property but covers the whole of the company’s property whether it is or is not subject to a fixed charge. When it crystallizes or becomes fixed, the assets thereafter comprised in the charge are subject to same restrictions and are affected in the same manner as under a specific charge.

Characteristics of a floating charge—where a company created a charge over its book debts, present and future, the characteristics of a floating were stated by Romer L.J. in a case as follows:

(1) It is a charge on a class of assets of the company both present and future.
(2) That class of assets is one which, in the ordinary course of the business of the company, is changing from time to time.
(3) It is contemplated by the charge that, until some steps are taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way.

The following cases may be noted in this regard:

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Indus Film Corpn. Ltd\textsuperscript{24} A Film Company borrowed a sum of money against all assets, including machinery, etc., then lying with the company or that might be bought thereafter until repayment. This was held to be a floating charge as it covered assets present and future of fluctuating nature and imposed no restrictions on the company to use them in any manner it liked.

Jones (J.D.) & Co. Ltd. v. Ranjit Roy\textsuperscript{25} A company borrowed a sum of money against all its machinery, stock in trade, and movable effects, present and future. By the terms of the deed, the properties were to remain in the possession of the lender. Held, this was a fixed charge as the company had lost the right to use the assets in the ordinary course of its business. As such if the assets are withdrawn from the business and are transferred to the lender’s possession, there is nothing over which the charge can float. The charge is already fixed on these assets.

3.12.2 Consequences of a Charge

The company can

(1) deal in the property on which a floating charge is created, till the charge crystallizes;

(2) notwithstanding the floating charge, create specific mortgages of its property having priority over the floating charge; and

(3) sell the whole of its undertaking if that if one of its objects specified in the Memorandum, in spite of the floating charge on the undertaking..

3.12.3 Crystallisation of a Floating Charge

Crystallisation is the conversion of a floating emerge into a fixed charge on the assets charged at the moments of crystallisation.

A floating charge crystallizes or gets fixed when—

(1) the company goes into liquidation, or

(2) the company ceases to carry on business, or

\textsuperscript{24} \textit{Indus Film Corpn. Ltd., Re}, A.I.R. (1939) Sind 100.
\textsuperscript{25} \textit{Jones (J.D.) & Co. Ltd. v. Ranjit Roy}, A.I.R. (1927) Cal. 682.
(3) a receiver is appointed, or

(4) a default is made in paying the principal and/or interest and the holder of the charge brings an action to enforce his security.

3.12.4 Distinction between Fixed Charge and Floating Charge

A specific charge is one that without more fastens on ascertained and definite property or property capable of being ascertained and defined; a floating charge, on the other hand, is ambulatory and shifting in its nature, hovering over and, so to speak, floating with the property which it is intended to affect, until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp.

3.12.5 Priority of Charges

1. *Priority of fixed charge over floating charge.* A fixed charge over the same assets has priority over the floating charge. This is because a company which has created a floating charge can, without the consent of the holder of the charge, deal in those assets in the ordinary course of business. The creditor who takes a subsequent specific mortgage will have priority over the floating charge even if he knows of the floating charge. But if the company is prohibited from creating subsequent specific mortgages, the creditor who takes a subsequent specific mortgage with notice of the prohibition shall have no priority over the floating charge.

2. *Fixed charge first in point of time takes priority.* When a fixed charge is created on the same property, the fixed charge which is first, in point of time, takes priority over the second.

3. *Prohibition of mortgages ranking in priority after crystallization of floating charge.* A company cannot create mortgages ranking in priority to the floating charge after it has crystallized. On crystallization the floating charge becomes a specific mortgage of the property which the company...

then owns and thereafter acquires, and the normal rules of priority apply between it and the mortgages created later.

4. *Prohibition of second floating charge having priority.* A company is allowed to create a second floating charge over its assets or undertaking. But the second floating charge cannot have priority over the first floating charge.

3.12.6 Effect of Winding up on Floating Charge (Sec. 332)

A floating charge on the undertaking or property of a company created within 12 months before the commencement of the winding up shall be void unless—

(a) the company was solvent immediately after the charge was created; and

(b) the amount was paid to the company in cash at the time of or subsequently to the creation of, and in consideration for, the charge together with interest at 5 per cent per annum or the rate prescribed by the Central Government.

The object of Sec. 332 of Indian Companies Act, 2013 is to prevent companies which are in insolvent condition from creating floating charges on their assets to secure past debts to the prejudice of their general (unsecured) creditors. Sec. 534 does not, however, affect a company which can prove that solvency is whether the company has been able to pay its debts as and when they become due, after the creation of floating charge Fixed assets are not to be taken into account when deciding on insolvency.

A floating charge created within a year before the commencement of the winding up is not invalidated if the company was solvent immediately after the charge was created.

These are various securities which are dealt in capital market. In case of shares the shareholders got dividend if the company have profit. The share may be equity share or preference share. In case of debenture the debenture holder got a fixed amount of interest. The debenture may be secured or unsecured or it may be redeemable or irredeemable. Bonds which are another
type of security are issued by public authorities, credit institutions, companies and super national institutions in the primary market. Bonds enable the issuer to finance long-term investment with external funds. A bond is a negotiable certificate which entitles the holder for repayment of the principal sum plus interest. A bond investor lends money to the issuer and in exchange, the issuer promises to reply the loan amount on a specified maturity date. Failure to pay either interest or principal on due constitutes legal default and court proceedings can be initiated to enforce the contract. Bondholders as creditors, have a prior claim over common and preferred stock holders regarding income and assets of the corporation for the principal and interest due to them. The most common process of issuing bonds is through underwriting. In underwriting, one or more securities firms or banks forming a syndicate buy an entire issue of bonds from an issuer and re-sell them to investors.

Government bonds are typically auctioned. In the Indian Securities market, the term ‘bond’ denotes the debt instruments issued by the Central and State Governments and public sector organizations. The term ‘debenture’ represents the debt instruments issued by the private corporate sector. Bonds have a fixed lifetime usually a particular number of years. But long-term bonds lasting over 30 years are rare. Some bonds have been issued with maturities of up to one hundred years and some even do not mature at all. Interest may be added to the end payment or can be paid in regular installments (known as coupons) during the tenure of the bond. Bonds may be traded in the bond market and are considered relatively safe investments when compared to equity. As stated above these corporate security is a charge upon the company assets. This may be secured or unsecured. If the charge is secured then investor is safe otherwise he is in safe. But it does not mean that a floating charge would never be fixed but it may turn into fixed charge after certain happening. What are these happening will depend upon the circumstances of each case.