

Debenture holders

Protection of debenture-holders' interests

The Companies (Amendment) Act, 2000 has inserted new sections 117A, 117B and 117C in the Companies Act, 1956, with a view to safeguarding the interests of debenture-holders of a company. In this article, the author sets out the salient features of the new provisions as well as the guidelines and regulations issued by the SEBI in this regard. The author welcomes the new provisions and the SEBI guidelines and regulations as positive steps towards development of a healthy debt market, but points out certain contradictions therein which need to be attended to - EDITOR

Introduction

1. After seeing a series of defaults made by companies in payment of interest and principal amount even in case of secured debentures, almost every investor who has invested his hard-earned money in such debentures is worried and puzzled as to whether, "investment in secured debentures is really secured?" In order to improve the deteriorating condition, the Government has introduced some provisions in the Com-

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panies Act, 1956 ('the Act') through the Companies (Amendment) Act, 2000 ('the Amendment Act') which are expected to go a long way in protecting the interests of debenture-holders. These provisions have been introduced by inserting three new sections 117A, 117B and 117C in the Act. It may be noted that earlier there was no specific provision in the Act for protection of interests of debenture-holders, although interests of other investors, *i.e.* shareholders and depositors, were duly protected.

Appointment of debenture trustee

2. The new section 117B prohibits a company from issuing a prospectus or a letter of offer to the public for subscription of debentures unless it has appointed debenture trustee(s) for such debenture issue and has stated on the face of the prospectus or the letter of offer that the debenture trustee(s) has/have given his/their consent to the company to be so **appointed. Any person who holds shares of the company or is entitled to receive money from the company or has given any guarantee in respect of principal debts secured by debentures or interest thereon cannot be appointed as a debenture trustee.** It is worthwhile to note here that as per the SEBI (Debenture Trustee) Regulations, 1993 only a Scheduled Bank, Public Financial Institution, Insurance Company or a body corporate can be appointed as debenture trustee. From the SEBI's stipulation it appears that an individual can't be appointed as a debenture trustee. Moreover, as per the SEBI (Debenture Trustee) Rules, 1993 no person shall act as a debenture trustee without obtaining a registration certificate from the SEBI. In view of this, it would have been appropriate if the same provision had been inserted in section 117B also so as to maintain uniformity between the Act and the SEBI Regulations. Appointment of debenture trustee is mandatory in case of a public issue of debentures through prospectus and rights issue of debentures. Even in case of debentures issued on private placement basis, trustees will have to be appointed because security has to be created in favour of debenture-holders which necessarily involves appointment of debenture trustee. In contrast to this, as per Chapter X of the SEBI (Disclosure & Investor Protection) Guidelines, 2000 (SEBI guidelines) which lays down guidelines for issue of debt instruments, appointment of a debenture trustee is compulsory only in the case of issue of debentures with maturity after eighteen months or more.

Trust deed

3. Section 117A(1) provides that a trust deed for securing any issue of debentures shall be in such form and shall be executed within such period as may be prescribed. Although no time-limit has yet been specified by Department of Company Affairs in this respect the SEBI guidelines provide that a trust deed shall be executed by the issuer company within a period of six months from the closure of the issue. The purpose of a trust

deed is to secure the issue of debentures by charging or mortgaging the property; forming the security for debenture-holders, in favour of trustees. It also provides the terms and conditions subject to which the charge is held and may be enforced by the trustees. The advantage of a trust deed is that trustees can act expeditiously and effectively in safeguarding the interests of debenture-holders and enforcing the security on their behalf. A copy of the trust deed shall be open to inspection by any member or debenture-holder of the company and he shall also be entitled to obtain copies of such trust deed. It may be noted that section 118 of the Act already gives right to any member or debenture-holder to obtain copies of and inspect the trust deed. Therefore, the aforesaid provision in section 117A(2) is just a repetition of the existing provision in section 118.

Functions of debenture trustee(s)

4. For the first time, functions of debenture trustees have been prescribed under the Act. Their main function shall be to protect the interest of debenture-holders and to effectively redress their grievances. Their incidental and ancillary functions shall be :

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

As far as calling a meeting of debenture-holders is concerned, the SEBI (Debenture Trustee) Rules, 1993 are much more stringent as according to these rules a debenture trustee shall call or cause to be called by the company a meeting of all the debenture-holders on a requisition in writing signed by at least one-tenth of the debenture-holders in value or on the happening of any event, which constitutes a default or which in the opinion of the trustees affects the interests of debenture-holders. Moreover, if debenture-holders are not satisfied with the performance of debenture trustees then at any of such meetings not less than 75 per cent of the debenture-holders can pass a resolution for removing the debenture trustees and if such a resolution is passed it can be a ground for cancellation of the registration certificate granted to the debenture trustee by the SEBI.

Application to CLB by debenture trustee(s)

5. Debenture trustees must ensure that the assets of the company and the guarantors are sufficient to discharge the principal amount at all times and where at any time they come to a conclusion that the assets of the company are insufficient or are likely to become insufficient to discharge the principal amount, they may file a petition before the CLB and the CLB may by an order impose such restrictions on the incurring of any further liabilities by the company as it may deem fit in order to protect the interests of debenture-holders.

Creation of security

6. Section 117C is titled, "liability of company to create security and debenture redemption reserve". However, there is no mention in this section regarding creation of security. Therefore, this issue needs to be resolved immediately. Still, we can draw an inference that this section makes it mandatory for every company to issue secured debentures only. In other words, debentures issued on private placement basis will also have to be backed by creation of security. Therefore, if no charge/mortgage is to be created for securing debentures, the company must ensure compliance of the Companies (Acceptance of Deposits) Rules, 1975 as unsecured debentures are treated as deposits under these rules.

In a number of debenture issues, it has been observed that security is created in favour of debenture trustees, for securing the debentures, by way of second or further mortgage and not as a *pari passu* charge on the assets of the company. In such cases, in the event of default, prior charge holders such as financial institutions and/or banks are paid first and a possibility always exists that after making payments to them, nothing is left to redeem the debentures. Therefore, in such debenture issues, most of the applicants, while making an application for allotment of debentures, are under an impression that debentures that will be allotted to them will be completely secured, but in reality such debentures are nothing more than unsecured debentures. In view of this, specific provisions need to be made in the Act with respect to creation of security so as to avoid such situations. In this regard, it may be noted that the SEBI guidelines provide for creation of security within six months from the date of issue of debentures and if a company fails to create security within twelve months it shall be liable to pay 2 per cent penal interest to debenture-holders. If security is not created even after eighteen months, a meeting of debenture-holders shall be called to explain the reasons thereof. Moreover, the issue proceeds have to be kept in an escrow account until the documents for creation of security as stated in the offer document are executed between the trustees and the company. In view of this, it would be appropriate if such investor protection measures are

included in the Companies Act also, as it will have a deterrent effect on the tendency of companies to delay the process of creation of security.

Creation of debenture redemption reserve

7. As per the provisions of section 117C(1), every company that issues debentures must create a debenture redemption reserve (DRR) to which it shall credit adequate amounts out of profits earned every year. Although this provision is a very welcome one, but it should be noted that there would be no DRR if the company fails to generate adequate profits or suffers losses continuously. Moreover, the section does not stipulate the quantum up to which DRR should be created, where as the SEBI guidelines provide that companies shall create DRR equivalent to 50 per cent of the amount of the debenture issue before the debenture redemption commences. In the absence of any stipulation in the Act, companies will have to decide upon the amount to be credited to DRR depending upon the amount of the debentures outstanding, adequacy of profits, tenure of debt etc. As per section 117C(2) the amount credited to DRR shall not be utilised for any purpose except redemption of debentures whereas the SEBI guidelines regard DRR as part of general reserve which can be utilised for issue of bonus shares. Therefore, there is contradiction between the two which needs to be sorted out at the earliest. Another area of contradiction between the SEBI guidelines and the Act is that as per the SEBI guidelines, any debenture issue with a maturity period of eighteen months or less is exempt from creation of DRR, whereas no such exemption has been provided under the Act.

Other important duties of Debenture Trustees prescribed by SEBI

8. Recently, the SEBI (Debenture Trustee) Regulations, 1993 have also been amended through the SEBI (Debenture Trustee) (Second Amendment) Regulations, 2000 which *inter alia* provide that it shall be the duty of every debenture trustee to appoint a nominee director on the Board of Directors of the company, in the event of two consecutive defaults in payment of interest on debentures or default in creation of security for debentures or redemption of debentures. The amended regulations also stipulate that communication should be sent by debenture trustees to debenture-holders on a half-yearly basis in respect of compliance of terms of issue by the company, as also defaults made by the company, if any, in payment of interest or redemption amount and action taken therefor.

Application to CLB by debenture-holders.

9. Just as section 58A(9) of the Act empowers the depositors to make an application to the CLB for repayment of matured deposits, the new section 117(4) extends a similar facility to debenture-holders for compelling a company to pay the redemption amount and interest due thereon.

However, there is a basic difference between the two sections, that is the CLB can act on its own motion in case of non-payment of deposits but under section 117C(4), that CLB can pass an order directing the company to redeem the debentures only on an application made by any or all the debenture-holders. Moreover, under section 58A(9) the CLB can direct by order a company to make repayment of deposit or part thereof forthwith or within such time and subject to such conditions as it may specify in the order. On the other hand, under section 117C(4), the order passed by the CLB shall be for redemption of full amount of debentures and interest due thereon forthwith. Therefore, under section 117C(4) no scheme of repayment can be considered by the CLB. In case any officer of the company fails to comply with the order of the CLB, he shall be punishable with imprisonment which may extend to three years and shall also be liable to a fine of not less than Rs. 500 for every day during which the default continues. This offence is not compoundable under section 621A of the Act.

Disqualification of directors

10. Further, a new clause (g) has been inserted in section 274(1) of the Act which provides that if a company fails to redeem the debentures on due date and if such failure continues for one year or more, then a person who is a director of the company at that time shall not be eligible to be appointed as a director of any other public company for a period of five years from the date of default. So, now directors of companies issuing debentures are likely to be much more vigilant and take all possible steps to ensure that debentures are duly redeemed on due date.

Conclusion

11. It is expected that the above measures, if implemented properly, will be very helpful in giving a boost to the sagging confidence of investors in the debt market and now more and more investors will prefer to invest their hard-earned money in debentures as they will look at debentures as a safe and secure investment opportunity with a decent return on investment. This will definitely pave the way towards development of a healthy debt market in the country.

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