THE NEW SCOPE OF 'DEBENTURES' UNDER THE COMPANIES ACT, 2013: DOES IT COVER COMMERCIAL PAPER?

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Abstract

Since its enactment on August 29, 2013, the Companies Act 2013 ("2013 Act") has progressively gained notoriety for opening up a can of worms and unsettling the status quo on many previously settled legal positions. One such debate concerns the changed definition of 'debentures' under the 2013 Act which, according to some, has blurred the distinction between negotiable instruments and marketable securities and could lead to the inclusion of negotiable instruments like Commercial Paper ("CP") within the ambit of 'debentures'. This issue has much relevance in commercial circles as a CP issuance is one of the most common routes taken by corporates and NBFCs for short-term investments and working capital. Many in corporate circles have expressed concerns that owing to this change, a CP issue could now require compliance with norms related to debentures under the 2013 Act. However, no clarity on this issue has emerged from the

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MCA. In this comment, the author has tried to reconcile this debate by conjointly reading the 2013 Act with the Securities Contract (Regulation) Act, 1956 ("SCRA"). It is the author's analysis that the changed definition is not an attempt to include all negotiable instruments within the ambit of debentures. Instead, the definition merely attempts to align the 2013 Act with prior judicial pronouncements of the Supreme Court. However, upon a conjoint reading of the 2013 Act with the SCRA, it may now be possible to include a CP within the ambit of a debenture.

I. GENESIS OF THE CONTROVERSY

The contentious definition of 'debentures' in the 2013 Act which kick-started this controversy is Section 2(30).[1] It reads as follows:

'Debenture' includes debenture stock, bonds and any other instrument evidencing a debt, whether constituting a charge on the assets of the company or not.

The parallel provision under the Companies Act 1956 ("1956 Act") was Section 2(12), which read as follows:

'Debenture' includes debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets of the company or not. Thus, while in the 1956 Act a debenture could only be a 'security', under the 2013 Act, it has now been amended to include 'any other instrument evidencing a debt'. In the light of this,

[1] § 2(30) was notified by the MCA on Sept. 12, 2013.

many believe that CP will now be covered in the definition of debentures.[2] However, to resolve this, one must find affirmative answers to the following 2 questions:

1. Are all instruments evidencing debt now debentures?
2. Has the scope of 'debentures' expanded in any way or are the changes merely syntactical?

II. RESOLVING THE CONTROVERSY

In attempting to resolve this controversy, one must invariably start at its source. The reason for many believing that CPs can now be included within debentures is the fact that a CP is essentially a promissory note and promissory notes themselves are an acknowledgement of debt. Section 4 of the Negotiable Instruments Act, 1881 defines a 'promissory note'[3] and illustration (b) to this section stipulates that a promissory note is an acknowledgement of a debt.[4] The same has also been held in several judicial pronouncements and is a settled position of law.[5] However, while one may make a preliminary argument based on this premise, it certainly cannot settle the debate once and for all. This is because such an assumption leads to the fallacious premise that any negotiable instrument evidencing debt can also be included in the definition of

[2]Maneka Doshi, Companies Act, *2013: NBFC Fundraising Tough*, THE FIRM (Apr. 14, 2014), http://thefirm.moneycontrol.com/story_page.php?autono=1069181.

[3]Negotiable Instruments Act 1881, § 4: A promissory note as an instrument in writing (not being a bank-note or a currency note) containing an unconditional undertaking signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument.

[4]Illustration (b) to Section 4: "I acknowledge myself to be indebted to B in Rs. 1,000 to be paid on demand, for value received."

[5]Bal Mukund v. Munna Lal Ramji Lal, (1970) AIR P&H 516; Shah Chimanlal Jagjivandas v. Khambhla Savji Bechar, (1955) AIR Sau 74; BHASHYAM & ADIGA, THE NEGOTIABLE INSTRUMENTS ACT 60-70 (Bharat Law House, 19th ed. 2012).

debentures. This leads us to the first question raised above: Did the legislature intend to include any and all negotiable instruments within the ambit of debentures?

This seems highly unlikely. Instead, the change proposed in the 2013 Act seems to be aimed at achieving an altogether different purpose. The changed definition doesn't seem so out of context when considered in light of the Supreme Court's judgment in the 1990 case of Narendra Kumar Maheshwari v. Union of India, which defined debentures as an acknowledgement of debt, with a commitment to repay the principal with interest.[6] Since the Supreme Court anyway defined a debenture as an acknowledgement of a debt, the intent seems to be to align the Companies Act with this position. Thus, most likely, the inclusion of the phrase 'any other instrument evidencing a debt' is merely an attempt to include all instruments which essentially acknowledge a debt but are known by different names, within the meaning of debentures. Thus, to assume that the changed definition includes any and all negotiable instruments within the ambit of debentures seems incorrect.

The next question which naturally arises is this: Whether the ambit of debentures has changed at all or is the change merely syntactical? It is this question which lies at the heart of this debate and demands a deeper scrutiny. Since it does not seem that the intent of the legislature was to include all negotiable instruments within debentures, it is unlikely that the underlying concept of debentures has undergone change. In light of this, a possible solution to this conflict can be given by construing 'debentures' on a combined reading of the 2013 Act and the SCRA. This is because a debenture is essentially a 'security' under the SCRA and its true import cannot be estimated in isolation with the SCRA. For the purposes of both the 1956 and the 2013 Act, 'securities' has been defined in Section 2(h)

[6]Narendra Kumar Maheshwari v. Union of India, (1989) AIR SC 2138.

of the SCRA.[7] Section 2(h)(i) of the SCRA defines 'securities' to include "shares, scrips, stocks, bonds, debentures, debenture stock and other marketable securities of a like nature". Thus, it would not be wrong to say that only those instruments evidencing a debt which are also securities can be debentures under the 2013 Act.

This naturally leads one to another question: What are securities? Interestingly, although the SCRA defines securities, the same is not an exhaustive definition. According to the Supreme Court in Sudhir Shantilal Mehta v. Central Bureau of Investigation, the definition is inclusive and must be interpreted expansively.[8] The Apex Court has also held that to fall within this definition, a security must be "marketable", and that for this purpose, "marketable" means "saleable", i.e. a security which is capable of being freely bought and sold in a market regardless of whether it is listed in a stock exchange.[9] However, to determine the true import of a 'security' under SCRA, a decisive test was laid down by the Gujarat High Court in Essar Steel Ltd. v. Gramercy Emerging Market Fund,[10] where the court had to decide whether floating rate notes (FRNs) were securities. In deciding this, the Court laid down the following test:

> "*The fundamental purpose underlying Securities Acts is to eliminate serious abuses in a largely unregulated securities market. There is virtually limitless scope of human ingenuity especially in the creation of the numerous schemes devised by those who seek the use of money of others on promise of profits.*

[7]This is reflected in § 2(81) of the 2013 Act (notified by the MCA on Sept. 12, 2013) and § 2(45AA) of the 1956 Act.

[8]Sudhir Shantilal Mehta v. Central Bureau of Investigation, (2010) 155 CompCas 339 (SC).

[9]Naresh K. Aggarwala and Co. v. Canbank Financial Services Limited, (2010) AIR SC 2722; Bhagwati Developers Private Ltd. v. Peerless General Finance & Investment Co. Ltd., (2013) 5 SCC 455.

[10]Essar Steel Ltd. v. Gramercy Emerging Market Fund, (2003) 116 CompCas 248 Guj.

> *The inclusive definition of the term 'security' is wide enough to include within that definition many types of instruments that might be sold as an investment. The term 'Note' is relatively broad to encompass instruments having different characteristics depending on whether issued in a consumer context as a commercial paper or in some other investment context. If the notes are issued in a commercial or consumer context, they will not be treated as securities while those issued in investment context would be securities. Whether the Note is issued in investment context can be ascertained on the basis of the circumstances surrounding the transactions. In order to determine whether a transaction involves a 'security', the transaction has to be examined to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a 'security'. On the other hand, if the note is exchanged to facilitate the purchase and sale of a minor asset or consumer goods, or to advance some other commercial or consumer purpose, such note cannot be classified as 'security'. One other factor to be examined would be whether the Note in question is an instrument in which there is common trading for speculation or investment and how is it views by the investing public.*"

Thus, to be a security, an instrument must both be marketable and used in an investment context. When one adopts such an approach, it becomes possible to include a CP within the ambit of a debenture without destroying the status quo. This is because:

Firstly, a CP is a "marketable" instrument. The RBI's treatment of the instrument makes this abundantly clear.

Secondly, a CP is used in the investment context in India. The RBI Master Circular on Commercial Papers, which presents the regulatory framework for CPs in India, sees CPs as a "source of short-term borrowings and an additional instrument for investors".[11] Although it uses the term "investment", this could indicate either of the two contexts and is ambiguous. To complicate matters further, while laying down the above test, the Gujarat High Court in Essar Steels also mentioned that CPs are used in the consumer context. Yet, this observation of the court is merely an obiter and cannot be treated as a decisive pronouncement on the subject. Moreover, one can argue that a CP is used in an investment context. The thrust of this argument can be derived from the accounting treatment given to CPs in India. Under Section 133 of the 2013 Act, the Central Government is required to notify accounting standards to be used by companies in preparing their financial statements.[12] Since the Central Government hasn't notified any accounting standards under the 2013 Act so far, the MCA has clarified that till such standards are notified, the standards notified under the 1956 Act shall continue to prevail.[13] Accordingly, accounting for investments is currently covered by AS 13. According to the ICAI, under AS 13, CP is seen as a current investment and is to be covered as a separate head under 'Investments' in a company's annual financial statement.[14] This provides a strong indication that CP is used in the investment context

[11]RBI Master Circular- Guidelines for Issue of Commercial Papers dated July 1, 2014.

[12]§ 133, Companies Act 2013: The Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under § 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

[13]Ministry of Corporate Affairs, General Circular No. 15/2013, dated Sept. 13, 2013.

[14]Compendium of Opinions, Vol. XII, Expert Advisory Committee, ICAI, New Delhi, Query No. 1.21; Compendium of Opinions, Vol. XIX, Expert Advisory Committee, ICAI, New Delhi, Query No. 28.

and can thus be covered under 'securities' in the SCRA. This would also justify its coverage under debentures.

III. INCLUSION OF CPS IN DEBENTURES- OPENING ANOTHER CAN OF WORMS?

Based on the discussion above, one can reasonably conclude that there exist some potent arguments to justify the inclusion of CPs in the ambit of debentures. However, even if CPs are included within debentures, the problems won't end there. In fact, that would open yet another can of worms under the 2013 Act. Some possible issues which could arise are as follows-[15]

a. Would provisions related to private placement under Section 42 of the 2013 Act now also apply to CPs? If so, this would automatically mean companies won't be able to do a new CP issue without the previous one having closed. However, this seems counterintuitive since in practice, a CP issue usually closes and ends on the same day.
b. If provisions related to private placements apply to CPs, privately placed CPs will also not be exempt from the requirement of creating a Debenture Redemption Reserve ("DRR") and putting 50% of the money raised through the CP issue into the DRR ahead of redemptions. Likewise, the liquidity requirement of having 15% of the total redemptions at the beginning of each year would also apply to a CP, since this now applies to a debenture.

[15] *Supra* note 2; Nidhi Bothra, *The Changing Defintion of Debentures*, INDIACORP (May 14, 2014), http://indiacorplaw.blogspot.in/2014/05/guest-post-changing-definition-of.html.

c. Will issue of a CP need a Board Resolution under Section 179(3) of the 2013 Act or would it need a special resolution as per Section 42 of the 2013 Act?

One possible resolution to this problem could be under Section 1 (4) (e) of the 2013 Act, which states that the provisions of a Special Act shall prevail over the provisions of the Companies Act, 2013. Considering the fact that a CP issuance is regulated by RBI under the powers derived from the RBI Act, which is a special Act, a CP is likely to continue to be regulated by the RBI and not under the 2013 Act.

IV. CONCLUDING REMARKS

On the basis of the foregoing analysis, we can conclude that although a CP can potentially be covered under the 2013 Act, there is still no clarity on the same. This uncertainty shall continue to prevail till such a time as the MCA decides to clarify on the same. However, in the meantime, it seems that a large number of companies have decided to err on the side of caution. According to public disclosures on websites of several companies, a CP issue is now being seen as a debenture and governed by Sections 42 and 71 of the 2013 Act. In order to enhance ease of business and bring clarity on this issue, the MCA must swiftly clarify the same. However, until this happens, the matter remains open to debate and further interpretation.