 DOI: http://doi.one/10.1732/IJLMH.25886

INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 4 | Issue 1

2021

Debentures and their Appeal to Investors and Companies

NIKHIL KARLE[1]

ABSTRACT

Recently, many large companies such as IIFL Finance, the Raymond Group, Muthoot Finance, and Indian oil have announced that they will be issuing large amounts of debentures in the near future. The aim of this paper is to be a comprehensive study of the concept of debentures. Debentures, also known as bonds, are a type of debt instrument that is issued by companies in order to raise capital. Debentures are unique, in that they are a debt instrument that is not backed by any collateral, however, despite this, they are considered to be a safe investment.

This paper seeks to explore the various types of debentures that can be issued by a company and the differences between debentures and shares. It also looks into whether companies should issue debentures in place of share, and in which situations this can be preferrable. The author also tries to understand the steps taken by the company with respect to the payment of interest, and redemption of debentures. Then, the author explores debentures from the perspective of investors, and looks into the remedies available to debenture holders in case of default by the company. Finally, the author looks into whether prospective investors prefer investing in debentures over shares, and their reasons for the same.

Keywords: Debentures, Bonds, Investors, Issuing Company, Debt Capital, Interest Rate, Redemption, Maturity, Trading, Security, Trustee

I. INTRODUCTION

In order to function, companies require large amounts of money in the form of capital. There are various methods through which companies can raise capital, such as issuing equity shares, creating profit reserves, and taking on debt in the form of loans. One of the ways a company can borrow money is by issuing debentures to the public. Debentures are debt instruments that are issued by companies with the intention of borrowing money from the public to raise capital[2]. They are usually medium to long-term debts, and are usually issued by large and

[1] Author is a student at School of Law, NMIMS Navi Mumbai, India.
[2] Debentures, James Chen and Gordon Scott, Investopedia, June 25th, 2020

 [ISSN 2581-5369]

established companies.

Debentures are usually a form of unsecured debt, which means that they are not backed up by any collateral[3]. According to the Companies Act 2013, the term "debenture" includes debenture stock, bonds or any other instrument of a company evidencing a debt, they are backed up by a collateral or not[4]. In most cases, debts are backed up by collateral, in that if the borrower is unable to honor the debt, the lender gets the asset that was agreed upon as collateral as compensation. Since most debentures are a type of unsecured debt, there is no guarantee that the company pays off the debt created by debentures. Because of the unsecured nature of debentures, investors only prefer purchasing debentures from firms that are reputable and creditworthy, making them a futile capital-raising option for new firms.

Governments can also issue debentures if they need to raise capital for infrastructural development. Such debentures are known as "Government Bonds", and these are considered to be one of the most secure forms of investment, due to the stable nature of government finances in comparison to private companies. In countries such as the US, private debentures are known as bonds, while government debentures are called "T-Bonds" or "Treasury Bonds"[5].

Like most debt instruments, debentures have a fixed rate of interest attached to them. This interest is paid periodically, and is treated the same way as interest on other debts such as bank loans. The company can pay off debentures through a process known as redemption. A unique feature of debentures is that they are transferrable, and can be traded in a manner similar to shares, but, unlike shares, debenture holders are not considered owners of the company, and do not have any inherent voting rights. Debentures usually have a higher face value than shares.

(A) Review of Literature

- ***The Unchanging Debenture, Hans Tjio, The Cambridge Law Journal, November 8th 2014 -*** This paper explores the history of debentures, and talks about how there have been minimal changes in the concept since their origins. The paper also looks into debentures in legislation and contracts, and explores the ambiguity of their definition in legal terms. It looks into the 2014 case of Fons HF vs Corporal Limited, in which Fons HF, a financier from Luxembourg, along with Kaupthing Bank Luxemborg SA, made unsecured loans to Corporal Ltd, a British company, in exchange for certain ordinary and preference shares. Rather than

[3] Debentures: An Unsecured, Long-Term Loan, Corporate Finance Institute
[4] Section 2(30), Companies Act 2013
[5] Debentures Explained, Dr Ravi Singh, IAS Forums, March 10, 2020

giving the claimants equity shares, Corporal Ltd instead gave Fons HF and Kaupthing Ltd debentures of the same value, justifying this by exploiting the ambiguous legal definition of debentures. The resulting court case laid down a more concrete and narrow definition of debentures. The author provides a detailed analysis of this case and the definition it laid down, and has applied this definition to past landmark judgements.

- ***Impact of Debentures on a Company and its Shareholders, Aayushi Sen and Vedanjali Mehta, International Journal of Research and Analytical Review, 22nd January 2019-*** This paper includes an analysis of the after effects of issuing debentures by collecting data from various enterprises that did so in the year 2018. The paper also looks into the effect that the issuance of debentures has on equity shareholders, and if the company had to take certain steps to ensure a balance between shareholders and debenture holders. The paper also briefly looks into the reasons for some investors preferring debentures to equity shares.

- ***A Study on the Issues and Problems Faced by Companies During the Redemption of Debentures, Kriti Sachan and Dr Rakesh Srivastava, Indian Journal of Financial Management and Accounting, March 15th 2017-*** This paper analyses the various problems that companies face with regards to debentures from issuance, to the payment of interest, to their redemption from an accounting perspective. It includes interviews with a former Company Secretary, who details the procedure and restrictions while issuing debentures, the method for the payment of interest on debentures, and the redemption of debentures on their maturity by setting up a Debenture Redemption Reserve.

- ***A Study on the Rights and Remedies Available to Debenture Holders, R Agalaya and M Kannappan, Indian Journal of Management, September 27th 2018-*** This paper looks into the rights of debenture holders with respect to companies defaulting on the payment of interest or defaulting on the redemption of debentures on maturity laid down by the Companies Act 2013. It includes an interview with an investor who had to deal with a company defaulting on the repayment of debentures after they had matured. The authors have then suggested certain additional rights that should be added in order to ensure that investors are protected in all possible scenarios.

- ***An Analysis of Convertible Debentures: Theory and Empirical Evidence, Dr. Eugene F Brigham, The Journal of Financial Management by the American Finance Association, March 1966-*** This paper has been written by Dr Eugene Brigham, a professor who is considered a leading author on financial management. The paper explores the concept of convertible debentures, which are debentures that can be converted into equity shares by debenture holders after a certain period of time. This paper is considered to be important because it includes a model and an equation for calculating the future value of equity shares that convertible debentures will amount to, while considering the change in value of shares and debentures from the date of issue to the date of maturity. This model is helpful because it can help companies predict the value of equity shares that debentures issued now will amount to, since it allows companies to make the best decision while issuing convertible debentures. It also helps investors, since they can calculate the amount of equity shares that their current debentures will amount to, allowing them to take the best decision while investing

- ***A Study on the Impact of Bonus Debentures on the Financial Performance of Selected Companies, Dr Amit Gupta and Dr Vishwadeep Sharma, International Journal of Marketing and Financial Management, July 2015-*** This paper analyses how different companies are impacted in different ways by issuing bonus debentures for existing shareholders. The five companies that the paper focused on were Britannia, Dr Reddy's Labs, Hindustan Unilever, Coromandel International, and AstraZenca. From the study, it was revealed that there was no change in the attitude of investors in Coromadel Intertantional, while the confidence of investors in Britannia and Dr Reddy's Labs increased after their decision to issue bonus debentures instead of dividend, whereas people who had invested in HUL and AstraZeneca reacted in a negative manner to a similar move.

- ***The Redemption and Re-Issue of Debentures: Its Effect on Security Transactions, Rod Howell and Andrew Jones, Bond Law Review, December 1994-*** This paper looks into the practice of companies repurchasing their own debentures rather than waiting for them to mature for redemption, and tries to understand the reasons for companies that do this and whether such transactions are effective. The paper establishes that companies repurchase their debentures and re-issue them back to the public, since such a reissue is not considered a new issue of debentures by the Securities and Exchange Commission, and that such transactions are performed when a company wants to issue debentures to certain creditors. The paper also explores scenarios of companies purchasing their own debentures at lower rates to avoid redeeming them or paying them off while winding up.

- ***Subordinated Debentures- Debt That Can Serve as Equity, Dr Robert W Johnson, The Journal of Finance, 1955-*** This paper is considered to be one of the first papers on debentures in America, and is also the first paper to explore the possibility that debentures could be converted into equity shares by the debenture holders. The reasoning that the author has provided for this is that a company can take on debt in the form of debentures and give investors the option to convert their debentures into equity shares to reduce debt in the future and also dilute ownership. The author reasons that this can also benefit the debenture holders as they can enjoy the guaranteed periodic interests of debentures while not being wary of defaults by the company, since they can convert their bonds into equity at any time.

- ***The Unlisted, Unrated Debenture Market, Alex Erskine, The FinSia Journal of Applied Finance, September 2008-*** This paper is written by Alex Erskine, who was the Chief Economist of the Australian Securities and Investments Commission at the time. It explored the popularity of debentures that were not rated by Credit Rating Institutions such as Standard & Poor's, Moody's, or Fitch in Australia, and were not listed on the stock exchange. The paper looks at such debentures in the light of the 2008 Mortgage Bond Financial Crisis, and explores whether such debentures are likely to have a similar effect in Australia.

- ***Financial Contracting Under Extreme Uncertainty: An Analysis of Brazilian Corporate Debentures, Christopher W Anderson, The Journal of Financial Economics, 1st January 1999***- This paper seeks to find out the reason behind corporate bonds and debentures being an extremely popular choice for investment among investors in Brazil, despite Brazil facing problems such as economic volatility, inflated transactional costs and fees, and fragile institutions that are not creditworthy or stable. This paper includes an analysis of 50 sample debentures, and finds that they have four common characteristics: (i) features that reduce the risk of inflation for investors, (ii) contingent-maturity mechanisms allow investors to exit or renegotiate periodically, (iii) no rules to restrict companies on their decisions with regards to debentures, and (iv) self-enforcement mechanisms that allowed companies to operate freely without being controlled by an overseeing institution. The paper concludes by saying that these four characteristics are helpful in popularizing debentures in the emerging and volatile economies that many developing countries had.

- ***No Pain, No Gain: Effecting Market Discipline Via "Reverse Convertible Debentures", Professor Mark J Flannery, Chapter 5 of* Capital Adequacy beyond Basel: Banking, Securities, and Insurance*, Oxford University Press, December 2005***- This paper explores the concept of Reverse Convertible Debentures, or RCDs, in which rather than the debenture holders having the option of converting their bonds to equity shares, the issuing company is given the option. The paper analyses situations in which such a conversion could benefit companies, and finds that the main benefit of such debentures is that companies could take on a higher amount of debt without necessarily being indebted, since if a company's debt is considered excessive later on, or if the company wants to take on debt through a different method without adding to their present debt, the board could simply decide to convert these debentures.

- ***The Perspective of Namibian Investors and Executives on Different Security Options, John Kagumbo, Justin Koetzee, and Dr Johannes Rheinwald, African Finance Journal, June 2018-*** This paper includes a survey that includes the opinions of both executives and investors on various types of securities in the country of Namibia. With regard to debentures, the survey shows that executives had a negative view of debentures since they believe there are better ways to take on debt, while investors also had a negative view of debentures, feeling that companies offering debentures were not stable or creditworthy.

(B) Research Objectives

1. To look into the various types of debentures that a company can issue.
2. To understand the differences between debentures and shares.
3. To understand the differences between debentures and bank loans.
4. To understand the advantages and disadvantages of issuing debentures.
5. To understand the steps a company takes to pay interest on debentures, and to redeem them.
6. To look into the remedies available to investors in case a company defaults in the repayment of debentures.
7. To look into factors that prospective investors have to consider before purchasing debentures
8. To see if prospective shareholders prefer investing in debentures or shares, and their reasons for the same.

(C) Research Methodology

This paper utilizes both primary and secondary sources of data. Secondary sources include journals, newspaper articles, books, interview transcripts, research papers, online articles, and blog posts. Such sources are a staple in most research papers nowadays, since the internet allows researchers to access high quality data compiled by experts. Primary sources include a survey of 30 investors and their views with regards to debentures. This survey was conducted online through the means of a Google form. A survey is a method of gathering and compiling information from a group of people, more often known as sample, with an intention of gaining knowledge by organizations, businesses or institutions. This information or opinion collected from sample, is more often generalization of what a large population thinks.

Surveys provide important or critical information in the form of meaningful data which is further used by businesses or organization to make informed and sound decisions.

II. FINDINGS

(A) Types of Debentures that Companies Can Issue

There are many different types of debentures that companies can issue. Companies can tailor the debentures they issue according to the needs that they have[6]. Debentures can be classified into various categories on the basis of whether they are secured or not, how long they take to mature, whether they can be converted to equity shares or not, whether they are registered or not, whether or not the company prioritizes their repayment, and whether they have a fixed rate of interest. They are:

ON THE BASIS OF SECURITY-

- **Secured Debentures-** These are debentures which are backed up by collateral. Collateral refers to a charge created against a fixed asset that is owned by the company. This means that in case the company defaults in the repayment of secured debentures, the ownership of the asset against which the collateral was created passes from the company to the debenture holders. In such cases, the asset is usually sold, and all of the debenture holders are paid off through the proceeds. Such debentures are rare since companies have other, more convenient methods of borrowing money backed up by assets as collateral, such as bank loans and mortgages[7].

- **Unsecured Debentures-** These are debentures which are not backed up by any collateral. Most debentures issued are of unsecured, since, as stated above, companies have better ways of getting secured debt. Unsecured debentures are beneficial to companies because they can raise money without creating a charge against their assets or diluting their ownership[8]. In case a company is unable to repay or defaults in the repayment of such debentures, the debenture holders are unable to recover the money they are owed. In most cases, unsecured debentures are issued by reputed and creditworthy companies, since prospective investors will not show interest in purchasing debentures from a new company[9].

[6] Impact of Debentures on a Company and its Shareholders, Aayushi Sen and Vedanjali Mehta, International Journal of Research and Analytical Review, 22nd January 2019
[7] A Study on the Issues and Problems Faced by Companies During the Redemption of Debentures, Kriti Sachan and Dr Rakesh Srivastava, Indian Journal of Financial Management and Accounting, March 15th 2017
[8] How Public Companies Raise Capital, Natalie Marideuna, Bloomberg Markets, July 27th 2019
[9] Investing in Debentures? Here's What You Need to Know, Jason Nash, Forbes Money, September 16th 2018

ON THE BASIS OF MATURITY

- **Redeemable Debentures-** Such debentures are issued with a specified date on which they will be redeemed. Redemption of debentures refers to the act of discharging the debt created by debentures through repaying the investors. Redemption can be done at par, premium, or profit depending on the situation. There are various ways in which companies can redeem debentures, such as through a lump sum payment, through instalments, by creating a debenture redemption reserve, etcetera[10]. In most cases, redeemable debentures are issued at low interest rates, since the debenture holders have the reassurance of knowing that their debt will be repaid.

- **Irredeemable Debentures-** Such debentures do not have a fixed date for redemption, and are hence only repaid once the company winds up. Due to this, debenture holders are not guaranteed to recover the value pf their debentures, since unsecured loans such as debentures are some of the last debts to be repaid. Despite this, many investors prefer investing in unsecured debentures, because their interest rates are considerably higher than redeemable debentures[11]. Such debentures are preferred since they usually have a high face value, and can be used to raise large amounts of unsecured capital. Many companies enforce a minimum investment value for such debentures[12].

ON THE BASIS OF CONVERTABILITY

- **Convertible Debentures**- Such debentures can be converted into equity shares by the debenture holders after a certain period of time. These debentures mitigate some of the risk that comes with unsecured debt, and are hence preferred by shareholders. Convertible debentures can also be called hybrid securities, since they are a combination of debt and equity instruments. Such debentures usually have a lower rate of interest[13].

- **Non-Convertible Debentures**- Such debentures cannot be converted into equity shares, and remain debentures for their lifetime. Usually Abbreviated as NCDs.

- **Reverse Convertible Debentures**- Such debentures can be converted into equity shares at the discretion of the issuer rather than the holder[14]. Such debentures are beneficial

[10]The Redemption and Re-Issue of Debentures: Its Effect on Security Transactions, Rod Howell and Andrew Jones, Bond Law Review, December 1994
[11] Niche Investments Every Investor Should Consider, Mike Schaeffer, CNN Money, December 11th 2019
[12] Irredeemable Debentures, Groww
[13] Investing in Debentures: A Guide, James Chen, Investopedia, 21st March 2020
[14] No Pain, No Gain: Effecting Market Discipline Via "Reverse Convertible Debentures", Professor Mark J Flannery, Chapter 5 of Capital Adequacy beyond Basel: Banking, Securities, and Insurance, Oxford University Press, December 2005

since they allow companies to take on high amounts of debt without necessarily feeling burdened by it.[15]

ON THE BASIS OF REGISTRATION

- **Registered Debentures**- The issuing company keeps the records of holders of such debentures. Hence, only the registered owners receive interest on these debentures. Such debentures cannot be transferred unless an instrument of transfer is sanctioned by the directors of a company.[16] Registered debentures usually have a higher rate of interest and are preferred by those making large investments.

- **Unregistered Debentures-** No records of ownership are kept for this type of debentures. This allows the holder of the debenture to receive interest, and ensures that this type of debenture is freely transferrable. The interest rate of such debentures is lower. Also known as bearer debentures.

ON THE BASIS OF PRIORITY

- **Preferred Debentures**- Such debentures are given first preference during the process of redemption. These usually have a lower rate of interest.

- **Ordinary Debentures-** Such debentures can be redeemed only after preferred debentures have been redeemed.

ON THE BASIS OF INTEREST

- **Specific Coupon Rate Debentures**- Such debentures have either a fixed or floating rate of interest attached to them. Such interest can be paid quarterly, half-yearly, or annually. A floating investment rate is usually linked the bank rate.[17]

- **Zero Coupon Rate Debentures-** Such debentures do not provide interest, but are issued at heavily discounted prices.

(B) Differences Between Debentures and Equity Shares

Debentures and Equity Shares are the two most popular ways in which corporations can raise capital through investments by the public. Whenever companies need to raise public capital, they are faced with a difficult decision regarding which security they should issue. In order to have a better understanding of the mindset of companies when making such a decision, we

---

[15] Reverse Convertibles: Complex Investment Vehicles, Dr Jeff Wittek, FinRa, October 17th 2011

[16] Debenture Registration Process, Dr Harshal Jain, ClearTax, 12th July 2018

[17] A Study on the Rights and Remedies Available to Debenture Holders, R Agalaya and M Kannappan, Indian Journal of Management, September 27th 2018

need to understand the differences between debentures and equity shares. These differences are-

Equity Shares	Debentures
Equity shares are a form of ownership capital, which means that shareholders will be considered part-owners of the company[18].	Debentures are a form of debt capital, which means that debenture holders will be considered creditors to the company.
Because of their position as part-owners of the company, equity shareholders have the right to vote on resolutions put forward by the company's directors in the company's Annual General Meeting.	Because debenture holders are considered creditors to the company, they have no voting rights. However, they have voting rights in any decisions taken by the company regarding their debentures[19]
Equity shareholders receive dividends. Companies can decide to distribute excess profits through debentures, but they are not forced to do so[20].	Debenture holders receive interest. Most debentures have a prefixed interest rate, and the company has to compulsorily pay timely interest.
No equity shares cannot be converted into debentures.	Some debentures can be converted into equity shares.
No equity shares are secured.	Some debentures can be secured.
Shareholders are the last people to be paid off after a company shuts down.	Debenture holders are paid off with the rest of the creditors.
All equity shares are transferrable.	Most, but not all debentures are transferrable.

(C) Differences Between Debentures and Bank Loans

When corporations want to raise capital by taking on long-term debts, they are usually faced with two main options- Debentures and Bank Loans. To understand how companies, decide on which method to borrow money through, we must understand the differences between

[18] Characteristics of Common Stock, Prof Patrick McReary, USC Law Review, January 2018
[19] Investing in Debentures: A Guide, James Chen, Investopedia, 21st March 2020
[20] "Procedure for Payment of Dividend Under Companies Act", CS Siddhartha Banik, TaxGuru

these two modes. These are-

Debentures	Bank Loans
Debentures can be secured or unsecured. Unsecured debentures are not secured by a collateral asset. If a company defaults in the repayment of unsecured debentures, then debenture holders do not have any way to recover their money[21].	Most bank loans are secured by collateral. What this means is that a charge is created against an asset owned by the company, and if the borrower defaults in the repayment of the loan, the ownership of the asset is transferred to the bank.
Interest on debentures is decided by the borrower. The company issuing debentures decides the rate of interest to be paid to the debenture holders[22].	Interest on bank loans is decided by the lender. The bank fixes the rate of interest to be paid by the borrowing company based on various factors.
Debentures can be repaid either periodically or entirely on maturity. What this means is that the issuing company has the option of making periodic payments towards the redemption of debentures or repaying them entirely on maturity[23].	Bank loans have to be repaid periodically. The borrowing company has to repay the loan in installments after adding the amount of interest already decided before the loan. The period differs from contract to contract, but monthly repayment is the most common.
Most debentures are freely transferrable. This means that the debenture holder can sell their debentures to another investor on the open market, and the new holder earns the interest on the debentures[24].	Bank loans cannot be transferred to another person or organization. The lending bank cannot shift the loan to another person and have to continue being a creditor for the entire period of the loan.

[21] Investing in Debentures? Here's What You Need to Know, Jason Nash, Forbes Money, September 16th 2018
[22] A Study on the Rights and Remedies Available to Debenture Holders, R Agalaya and M Kannappan, Indian Journal of Management, September 27th 2018
[23] The Redemption and Re-Issue of Debentures: Its Effect on Security Transactions, Rod Howell and Andrew Jones, Bond Law Review, December 1994
[24] Investing in Debentures: A Guide, James Chen, Investopedia, 21st March 2020

(D) Advantages and Disadvantages of Issuing Debentures

ADVANTAGES TO COMPANIES

- **Long Term Capital-** Debentures are a form of long-term debt instruments. This means that capital raised through debentures can be utilized by the company over a longer period of time[25]. Moreover, companies can choose to repay debentures entirely at maturity rather than periodically. Some companies create a reserve known as the Debenture Redemption Reserve in which they store a certain amount of excess profit with the intent of using this reserve to redeem debentures[26].

- **Lower Interest Rate-** The rate of interest to be paid on debentures is usually lower than that to be paid on bank loans. This is because the issuing company decides the rate of interest on debentures, rather than the lender[27].

- **No Charge Against Assets-** Since most debentures are unsecured debt instruments, they are issued without collateral, and no charge is created against the assets owned by the company. If the company decides to issue from the bank instead, assets owned by the company will have to be mortgaged, or kept as collateral against the loan[28].

- **No Dilution of Ownership-** Debentures do not have any voting rights attached to them, which means that debenture holders do not have the right to vote on resolutions in the company's Annual General Meeting. Because of this, debenture holders are not considered to be part-owners of the company like equity shareholders are[29].

- **Tax Write-Off-** Interest paid on debentures is a tax-deductible expense, making paying interest on debentures considerably less expensive than paying dividend to shareholders, since dividends are not a tax-deductible expense.[30]

ADVANTAGES TO INVESTORS

- **Stable Income-** Investing in debentures allows shareholders to receive interest periodically, which allows them to have a stable source of income. This is in contrast to equity shares, since dividend paid on equity shares is not guaranteed, and companies can

[25] Debentures: An Unsecured, Long-Term Loan, Corporate Finance Institute
[26] The Redemption and Re-Issue of Debentures: Its Effect on Security Transactions, Rod Howell and Andrew Jones, Bond Law Review, December 1994
[27] Debentures: A Sweet Spot Between Equity and Bank Loans, Vivek Goswami and Rishabh Verma, Economic Times
[28] Ibid
[29] Characteristics of Common Stock, Prof Patrick McReary, USC Law Review, January 2018
[30] Corporate Tax in India- An Overview, Shaun Aron Abraham, ClearTax, February 3rd 2020

choose whether to pay dividend or not. Conservative investors usually prefer debentures for this reason[31].

- **Higher Chance of Repayment-** Debentures have a higher chance of being repaid than equity shares, since, a lot of debentures are redeemable, which means that they are repaid after a certain period of time elapses. Even irredeemable debentures have a better chance of being repaid than equity shares, since debtors are repaid before shareholders in case a company shuts down.

- **Secure Investment-** The interest of debenture-holders is protected by various provisions of the debenture trust deed and the guidelines issued by the Securities and Exchange Board of India in this regard[32]. The price of debentures is much more stable compared to the price of equity shares.

DISADVANTAGES TO COMPANIES

- **Fixed Rate of Interest**- Since the rate of interest on debentures is fixed, companies have to continue paying this interest even if they face losses. This is in contrast to dividend, since dividend can be paid only when there is a profit. If a company defaults in the payment of this interest, it has a severe negative effect on the reputation and creditworthiness of the company[33].

- **Only Available to Certain Companies**- Since one of the main advantages of debentures is that they are unsecured, only established, creditworthy companies with a good reputation can issue unsecured debentures. Investors are averse to providing unsecured debt to budding companies, which means that new companies only have the option of issuing secured debentures. Most new companies would prefer to take a bank loan than issue secured debentures[34].

- **High Stamp Duty**- Stamp Duty to be paid on the issue of debentures is higher than that paid on equity shares.[35]

DISADVANTAGES TO INVESTORS

- **No Voting Rights-** Debenture holders do not have no voting rights when it comes to resolutions on the agenda at a company's Annual General Meeting. They only have the right to vote on matters that directly concern the debentures that they own.[36]

---

[31] Niche Investments Every Investor Should Consider, Mike Schaeffer, CNN Money, December 11th 2019
[32] SEBI Guidelines for Issuing Debentures, Danish Khan, LearnAccounts, November 6th 2018
[33] Debentures: An Unsecured, Long-Term Loan, Corporate Finance Institute
[34] Debentures Explained, Dr Ravi Singh, IAS Forums, March 10, 2020
[35] Ibid

- **No Ownership Rights-** Debenture holders are considered to be creditors to the company, while shareholders are considered to be owners of the company. What this means is that all decisions that the company takes are to benefit the shareholders rather than the debenture holders[37].

- **Taxable Interest-** Debenture holders have to pay tax on interest since interest on debentures is fully taxable. This is in contrast to dividends on shares, as shareholders do not have to pay any tax on the dividend that they may receive from the company[38].

- **Cost-** Debentures are considerably more expensive than equity shares, making them a difficult investment for many shareholders, as they could purchase larger amounts of equity shares for the same price[39].

(E) Procedure for Payment of Interest and Redemption of Debentures

PAYMENT OF INTERESTON DEBENTURES

Like all debt instruments, companies have to pay debenture holders interest as a reward for loaning their money to the company. The rate of interest on debentures is decided by the company issuing them, unlike bank loans where the creditor decides the rate of interest[40]. This rate usually differs for different types of debentures. For example, Unsecured debentures have a higher rate of interest than secured debentures, registered debentures have a higher rate of interest than unregistered debentures, Non-convertible debentures (NCDs) and Reverse Convertible Debentures (RCDs) have a higher rate of interest than convertible debentures, etc[41].

Interest is paid on the face value of debentures rather than the current market value. This means that the interest is paid on the value at which the debenture was issued rather than the current market price of the debentures. This allows for the interest on debentures to be consistent for the entirety of its life. The periodic payment of interest can be fixed by the company in accordance to their situation at the time of issuing them. The payments can be monthly, quarterly, half yearly, or annually. Most companies prefer a quarterly or half-yearly method of payment for the convenience of accounting. Interest on debentures has to be paid regardless of whether a company makes a profit or loss.

---

[36] Investing in Debentures: A Guide, James Chen, Investopedia, 21st March 2020
[37] Characteristics of Common Stock, Prof Patrick McReary, USC Law Review, January 2018
[38] Investing in Debentures: A Guide, James Chen, Investopedia, 21st March 2020
[39] Everything to Know Before Your First Foray into The Stock Market, Susan Antonyan, RobinHood, December 11th 2018
[40] A Study on the Rights and Remedies Available to Debenture Holders, R Agalaya and M Kannappan, Indian Journal of Management, September 27th 2018
[41] Investing in Debentures? Here's What You Need to Know, Jason Nash, Forbes Money, September 16th 2018

The Income Tax Act of 1961 states that the maximum annual limit on interest per debenture is Rs 5000[42]. Any interest beyond this will be taxed. The tax on such interest has to be deducted by the issuer, which means that the company itself should deduct the tax and pay the amount to collected to the Central Government on behalf of the debenture holders. This is tax is known as Tax Deducted at Source or TDS. The limit for interest value on which TDS applied was raised from Rs 2500 to Rs 5000 in the year 2012.[43]

PROCEDURE FOR THE REDEMPTION OF DEBENTURES

The redemption of debentures refers to the process of repaying the amount borrowed from the public through debentures. Companies can choose to redeem debentures at premium or at par (the nominal or face value at which the debenture was issued). Sometimes companies make up for unpaid interest by redeeming at a premium. There are four ways in which a company can redeem the debentures issued by it[44]. These are:

1. **Payment in Lump Sum-** In this method of redeeming debentures, the company repays all debentures from a batch at once on their maturity. Such a method is preferred by companies that require a high working capital. Companies have to create a Debenture Redemption Reserve or DRR[45] with the objective of paying off debentures in a lump sum. Companies put a part of their profit every year into a DRR and use this reserve to pay off the debentures at maturity. For example, If XYZ Inc issues debentures worth Rs 10,000 that mature after 10 years, the company can put away Rs 1000 from their profit into a Debenture Redemption Reserve. Through this, they can pay off the entire value of the debentures on maturity using just these reserve profits.

2. **Payment in Instalments-** Some companies may prefer to redeem debentures by paying them off in parts or instalments. This method is preferred by companies that can maintain a steady cash flow. The company divides the total amount of debenture capital by the number of years the debentures take to mature, and begin paying them off annually. For example, if a company issues debenture worth Rs 10,000, it can decide to repay the debenture capital in instalments of Rs 1000 per year.

3. **Purchase in the Open Market**- Sometimes, companies may redeem debentures by purchasing those listed on the stock exchange. If the value of the debenture decreases over its

[42] Section 191, Income Tax Act, 1961
[43] TDS Limit on Debentures Raised, Ankush Sharma, TaxGuru, 16th March 2012
[44] A Study on the Issues and Problems Faced by Companies During the Redemption of Debentures, Kriti Sachan and Dr Rakesh Srivastava, Indian Journal of Financial Management and Accounting, March 15th 2017
[45] Section 71(4), Companies Act, 2013

lifetime, and is listed for less than the nominal value, the company can redeem the debentures at a discount and make a profit.

4. **Conversion into Equity Shares-** Convertible debentures can be redeemed by converting them into equity shares. By doing this, the debt capital of a debenture is converted into equity capital.

The procedure to redeem debentures is fairly consistent among companies. This procedure was laid out in the research paper "A Study on the Issues and Problems Faced by Companies During the Redemption of Debentures" by Kriti Sachan and Dr Rakesh Srivastava. The paper contains an interview with a former Company Secretary, who lays out the procedure for the author. This procedure is as follows-

1. **Board Meeting-** The company first has a board meeting in which the directors approve a resolution to redeem debentures[46].

2. **Informing Debenture Holders-** The company then informs the debenture holders about their decision to redeem debentures. This needs to be done through an official company letter sent by the Company Secretary. The letter asks the debenture holders to surrender their debenture ownership certificates[47].

3. **Repayment-** After all share certificates have been surrendered, the Company Secretary has to inform the company's bankers to transfer the amount to be repaid to the debenture holders[48].

4. **Changes in Register of Debenture Holders-** If the debentures redeemed were registered, then the necessary changes are made to the register of debenture holders by the Company Secretary[49].

5. **Changes in Register of Charges-** If the debentures issued were secured, then the charge made against the assets kept as collateral is lifted[50].

6. **Informing the Registrar of Companies-** Finally, the company secretary has to inform the registrar of companies about the redemption of debentures[51].

---

[46] A Study on the Issues and Problems Faced by Companies During the Redemption of Debentures, Kriti Sachan and Dr Rakesh Srivastava, Indian Journal of Financial Management and Accounting, March 15th 2017

[47] Ibid

[48] Ibid

[49] Ibid

[50] Ibid

[51] Ibid

(F) Remedies Available to Investors if a Company Defaults in the Repayment of Debentures

If debentures issued by a company are purchased by more than five hundred people, the company has to appoint an entity known as a debenture trustee.[52] The debenture trustee is an entity who protects the interests of the debenture holders and addresses their grievances.[53] In most cases, debenture trustees are scheduled banks or insurance companies.[54] The issuing company creates a deed in favor of the appointed trustees with the aim of protecting the interest of the debenture holders. Such a document is called a debenture trust deed.[55] If the debenture trustee feels that the assets of the issuing company are not enough to repay the debenture holders on maturity, the trustee can go before the National Company Law Tribunal on behalf of the debenture holders.[56] In case there are less than 500 individual debenture holders, the debenture holders themselves can approach the Tribunal.

If the issuing company fails to redeem debentures on maturity or fails to pay timely interest, then the trustee or the debenture holders can approach the National Company Law Tribunal, which can then order the company to pay the interest or redeem the debentures[57]. If the company fails to comply with the orders of the NCLT, then every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than two lakh rupees but which may extend to five lakh rupees, or with both.[58]

In order to comply with such orders, the company can sell assets in order to raise money for the redemption. This applies to both secured and unsecured debentures. In case of secured debentures, the company has to sell the specific asset attached as collateral, whereas in the case of secured debentures, the company can sell any asset or assets of their choice.

(G) Factors to Consider Before Purchasing Debentures

While purchasing debt bonds such as debentures, investors have to take certain risks. To mitigate these risks, there are certain factors that are to be considered by investors-

- **Creditworthiness and Reputation**- One of the biggest risks that investors take when purchasing debentures is the fact that companies may default in the payment of interest or

[52] Section 71(5), Companies Act, 2013
[53] Section 71(6), Companies Act, 2013
[54] The Appointment of Debenture Trustees, Rahul Kulkarni, iPleaders, October 2019
[55] Section 71(7), Companies Act, 2013
[56] Section 71(9), Companies Act, 2013
[57] Section 71(10), Companies Act, 2013
[58] Section 71(11), Companies Act, 2013

repayment. Since many debentures are unsecured, investors do not have a guarantee that the company will repay their debt. For this reason, prospective investors should only purchase debentures from companies that enjoy a good reputation n the market, and are deemed to be creditworthy[59]. The creditworthiness of companies is determined by their previous history with debt. Companies that repay their debts in a timely fashion are considered creditworthy, and hence it is less of a risk attached to their debentures. However, this does not mean that a reputable and creditworthy company is guaranteed to repay their debts, as unforeseeable problems may arise in the future[60].

- **Returns-** Every investor looks into what returns debentures offer. But investors should know that the bonds with the biggest returns are usually the ones with the most risk attached to them, while the most secure bonds usually have low returns. Investors must find the middle ground, in which a debenture has considerable returns while also being relatively less risky[61].

- **Ratings-** Agencies such as Standard & Poor's, Fitch, and Moody's provide ratings for bonds, with the best rating being AAA or Triple A. These agencies analyze the bond and the various factors attached to it, and provide it with a rating based on how secure it is. Such ratings are always helpful to investors, but they should also do their own research and not just consider agency ratings, as there are still many factors that these agencies do not look into. According to Krishnan Sitaraman, a senior director with analytics company Crisil, the industry and the field of the issuing company also have certain differences which rating agencies do not consider. In an interview with LiveMint, he said that finance companies with a AAA rating will have a higher yield than manufacturing companies with a AAA rating simply because of the field they are in.[62]

(H)A Survey of Investors About Debentures

A survey is a method of gathering and compiling information from a group of people, more often known as sample, with an intention of gaining knowledge by organizations, businesses or institutions. This information or opinion collected from sample, is more often generalization of what a large population thinks. Surveys provide important or critical information in the form of meaningful data which is further used by businesses or organization to make informed and sound decisions. The objective of this survey was to

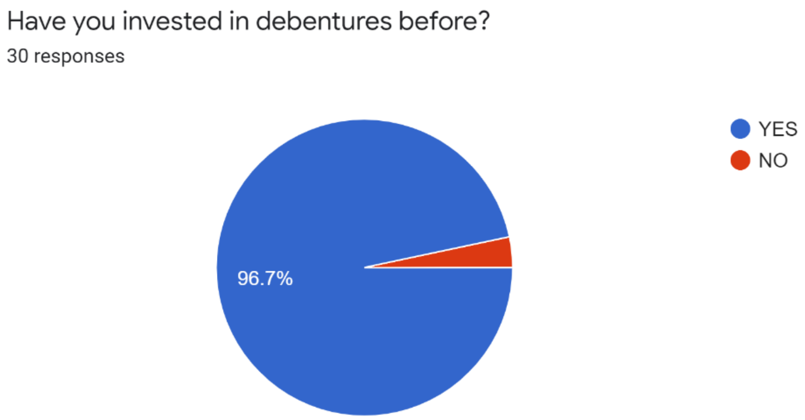
[59] Investing in Debentures? Here's What You Need to Know, Jason Nash, Forbes Money, September 16th 2018
[60] Investing in Debentures: A Guide, James Chen, Investopedia, 21st March 2020
[61] 7 Common Mistakes While Buying Bonds, Glenn Curtis, Investopedia, August 6th 2018
[62] 5 Things to Look At Before Buying Bonds, Kumar Gautam, LiveMint, April 2019

understand whether shareholders preferred investing in shares or debentures. It was conducted through the medium of google forms and was answered by thirty investors. The questions asked were as follows-

- Have you invested in debentures before?
- Would you consider investing in debentures in the future?
- Which factors do you give the most importance to before purchasing debentures?
- Would you consider investing in the debentures of a new company?
- Do you prefer secured or unsecured debentures?
- If you had the option between purchasing equity shares and debentures, what would you rather purchase?

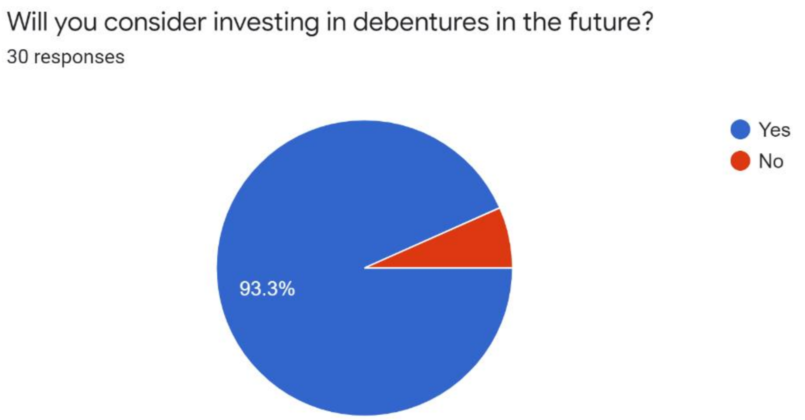
Every investor also had to give reasons for every answer but the first one.

Q1. Have you invested in debentures before?



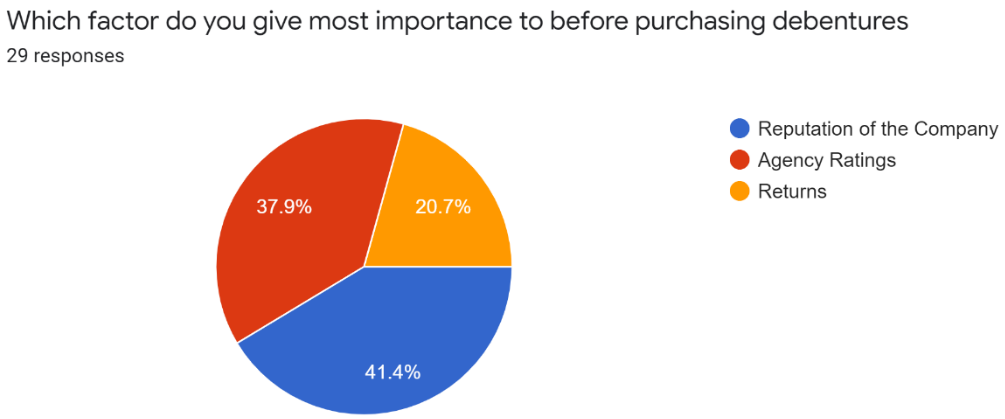
All but one person who answered this survey has invested in debentures before.

Q2. Would you consider investing in debentures in the future?



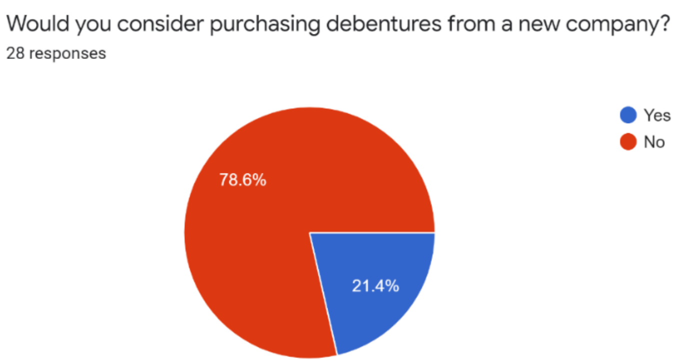
28 people who answered the survey said they would consider investing in debentures in the future, while two people said they would not consider purchasing debentures in the future. The person who has never invested in debentures said that they would not consider investing in them in the future, reasioning that they would not consider investing in them after the 2008 mortgage bond crisis. The other person who said they would not consider investing in debentures in the future. Their reason for this was that they had previously purchased debentures for Jindal Steel on the open market, and the company defaulted in their first interest payment. The person said that after this happened, they cut their losses and sold the bonds, and will never consider purchasing them in the future

Q3. Which factors do you give the most importance to before purchasing debentures?



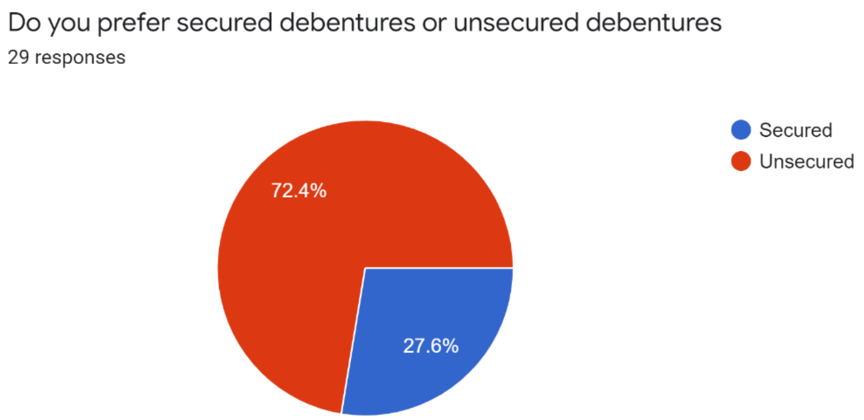
A slight majority of people gave the most importance to the reputation of the company. The reason most people gave for this was that reputed companies were the most creditworthy. Most of them also stated that they stopped giving a lot of importance to agency rating after the 2008 mortgage bond crisis. Many of the people who said their main focus was agency ratings said that they preferred it when experts analyzed risks for them as it saved them time and effort. A majority of the people who gave the most importance to returns said that they did so because they invested money that they could afford to lose and wanted to maximize profit on.

Q4. Would you consider investing in the debentures of a new company?



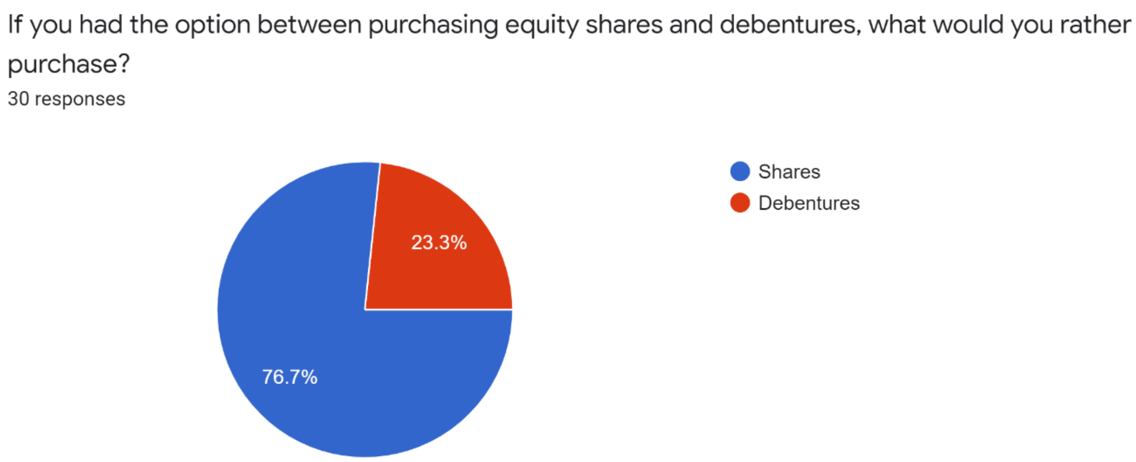
A majority of people said that they would not consider purchasing debentures from a new firm, saying that it was too much of a risk as the company's creditworthiness was not proven. Almost everyone who said yes said that they would only purchase secured debentures and invest a small amount.

Q5. Do you prefer secured debentures or unsecured debentures?



A majority of people said they would rather invest in unsecured debentures, as the rate of interest on them would be higher. Most of the people who said they preferred secured debentures reasoned that it was better to be safe, and a few of them said that they invest larger amounts to compensate for the lower interest rate.

Q6. If you had the option between purchasing equity shares and debentures, what would you rather purchase?



A majority of people said that they would prefer purchasing equity shares to debentures, reasoning that they had more experience in making profits through the sale and purchase of shares, and that was what they felt comfortable investing in. Those who preferred debentures said that they liked the stable income they received from them.

VIEWS OF THE AUTHOR AND CONCLUSION

I feel that debentures are a much safer investment than equity shares, since they offer regular payment in the form of interest, and have a higher chance of being paid off than equity shares. However, I feel that investors should not feel the need to choose between debentures and shares, as they serve two very different purposes. People invest in debentures with the aim of receiving guaranteed and timely interest, whereas investments in equity shares are made with the intent of waiting for them to increase in value before selling them at a profit. I noticed certain trends while tabulating data for the survey above, and tried to come up with reasons for them. These were as follows-

- **Everybody who gave the most importance to returns said they would consider purchasing debentures from a new company**- The likely cause for this was that newer companies provide higher rates of interest.
- **Most people who would consider purchasing debentures from a new company preferred investing in shares over debentures**- This is probably because both are high risk, high reward options.
- **Nobody who gave the most importance to reputation or agency ratings said they would buy debentures from new companies-** This is obviously because new companies will have little to no reputation and low rated bonds.
- **Nobody who preferred secured debentures would consider purchasing debentures issued by a new company-** This is likely because those who prefer secured debentures have a conservative mindset with regards to investing and do not want to take risks.
- **Most people who preferred secured debentures to unsecured debentures gave the most importance to returns-** This is because secured debentures have lower rates of interest.
- **Everybody but one person who preferred debentures to shares preferred secured debentures to unsecured debentures-** This is because shares are riskier.
- **Everybody who gave the most importance to returns preferred unsecured debentures to secured debentures-** This is because secured debentures have lower rates of interest.

- **Everybody who preferred secured debentures over unsecured debentures preferred debentures over shares-** This is likely because those who prefer secured debentures have a conservative mindset with regards to investing and do not want to take risks.

This paper looks into the concept of debentures and the perceptions of investors regarding them. It begins with a brief introduction to the topic and looks into various research papers written about it. Then the paper tries to look into the various types of debentures that companies can issue. It then differentiates debentures from equity shares and bank loans, which are two alternative forms of raising capital. The paper looks into the advantages and disadvantages of debentures, from the point of view of both investors and companies, after which the paper focuses on the procedure for the payment of interest and redemption of debentures. Then the paper details the remedies available to investors in case a company defaults on payments, and showcases certain factors which investors should consider before purchasing debentures. Finally, the paper includes the findings of a survey of thirty investors and their opinions regarding debentures.

*****

 [ISSN 2581-5369]