

ISSN: 2582-6433



INTERNATIONAL JOURNAL FOR LEGAL RESEARCH AND ANALYSIS

Open Access, Refereed Journal Multi Disciplinary
Peer Reviewed 6th Edition

VOLUME 2 ISSUE 7

www.ijlra.com

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INTERNATIONAL JOURNAL FOR LEGAL RESEARCH & ANALYSIS

ISSN

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SHARE CAPITAL AND DEBENTURE

Authored By - Pravesh

ABSTRACT

When it comes to raising capital for a company, there are two common methods: issuing shares or debentures. Share capital and debentures are two distinct ways companies can raise money, and understanding the differences between them is essential for investors and business owners. Share capital refers to the money that is raised by a company by issuing shares to investors. These shares represent a portion of the ownership of the company and give shareholders the right to vote on important decisions and receive a portion of the profits through dividends. Share capital can be raised through an initial public offering (IPO), where a company goes public and sells its shares on the stock market, or through private placements, where shares are sold directly to investors.

Debentures, on the other hand, are a type of debt instrument that companies issue to raise money. Essentially, debentures are a promise to repay a loan with interest at a specified date in the future. Debentures are similar to bonds, but while bonds are generally issued by government entities or large corporations, debentures are typically issued by smaller companies. They are usually unsecured, which means they are not backed by any specific business assets, and they often have higher interest rates than secured loans.

SHARE

Under Section 2(84) of the Companies Act, 2013 'share' means a share in the share capital of a company and includes stock. A share, therefore, refers to a unit in which the share capital of a company is divided. It represents a portion of the company's capital and entitles the shareholder to certain rights, such as voting rights and a share in the company's profits.¹

¹ The Companies Act, 2013, section 2(84).

SHARE CAPITAL

Share capital is the total amount of money raised by a company from its shareholders by issuing shares. Each share represents a unit of ownership in the company and entitles the shareholder to certain rights, such as the right to vote on important company matters, receive dividends, and participate in any share buyback programs. It refers to the money invested by shareholders in a company in exchange for ownership rights. This capital is an essential source of funding for companies, enabling them to finance their operations, invest in growth, and reward shareholders through dividends and share buybacks.²

DIFFERENT TYPES OF SHARE CAPITAL

There are generally two types of share capital:

1. **Equity Share Capital:** This represents the ownership of the company. Shareholders have the right to vote in meetings of shareholders. If a company makes a profit, they also receive dividends. If the company is dissolved, they have the right to receive a part of the company's assets.
2. **Preference Share Capital:** They are like a hybrid security having a combination of both equity and debt. They receive dividends first and have the right to recover their capital in the event of the company's liquidation. However, they generally do not have voting rights in the company.

Within each of these two types of share capital, there can be various subclasses, such as:

- **Ordinary shares:** These are the most commonly used shares and represent ownership in the corporation. They have the right to vote at the meetings of shareholders and also receive dividends if the company distributes profits.
- **Cumulative preference shares:** These shares entitle their holders to accrue unpaid dividends if the company does not pay the dividend in a given year. Cumulative dividends must be paid before any dividend is paid to common shareholders.
- **Redeemable shares:** Redeemable shares are shares that a company can redeem on a predetermined date or at a predetermined place.

² Avtar Singh, Company Law, 17th Edition (EBC, Lucknow, 2020) 37-48.

- Non-voting shares: They do not give their holders the right to vote at shareholder meetings, but they may still be entitled to receive dividends and other shareholder rights.
- Deferred shares: Deferred shares are a type of non-voting share that only receives dividends once all other classes of shares have received a certain amount of dividends.
- Founders' shares: Founders' shares are generally issued to the founders of a company and may have special rights, such as the ability to appoint directors or veto certain decisions.
- Participating Preference Shares: These shares have the right to receive additional dividends beyond the fixed rate if the company performs exceptionally well.³

ALLOTMENT OF SHARES

It is the process by which a company issues new shares to investors or existing shareholders. This can occur in various circumstances, such as an initial public offering (IPO), subsequent public offering, private placement, or rights issue.

During an allotment of shares, a company may set a specific price for the shares or allow the market to determine the price through an auction or other mechanism. Once the price is set, the company will allocate the shares to the buyers or shareholders who have agreed to purchase them.

Allotment of shares can have important implications for both the company and the investors involved. For the company, issuing new shares can raise capital that can be used to fund growth or other strategic initiatives. For investors, buying new shares can provide an opportunity for capital appreciation and the possibility of future dividends. However, investors should carefully consider the risks and potential rewards of buying new shares and may seek professional advice before making any investment decisions.⁴

³ Company Law, Executive program, Module 1, Paper 2, The Institute of Company Secretaries of India, 2018.

⁴ Dutta, A. K., & Roy, P. (2019). Share Capital and Debentures of Indian Companies: An Empirical Study. *Journal of Accounting and Finance*, 19(2), 67-82.

FORFEITURE OF SHARES

It is the process of cancelling shares for which shareholders have not paid the amount due. Lost shares will be reissued or sold to new shareholders. It is important to note that the shares forfeited do not exempt the shareholder from paying the amount due on the shares. If the amount owed for the shares is more than the amount of the forfeited shares, then the company has the right to recover the remaining amount.

The procedure for forfeiture of shares is as follows:

1. The Board of Directors must decide to forfeit the shares for non-payment of calls or other amounts due on them.
2. The company must give notice to the shareholder, stating the amount due on the shares, the date on which they will be forfeited, and the consequences of forfeiture.
3. Notices should be sent by registered or express mail to the shareholder's registered office, or by email if the shareholder has provided an email address.
4. If the shareholder does not pay the amount due for the shares within the time stated in the notice, the company will forfeit the shares.
5. The company must then make an entry in the register of members, record the forfeiture of the shares, and cancel the share certificates.
6. The forfeited shares may be sold or otherwise disposed of by the company, and the proceeds of the sale may be used to pay any amount due on the shares and any costs incurred by the company in connection with the forfeiture and sale.
7. If the proceeds of the sale exceed the amount due on the shares and the costs incurred by the company, the remainder must be paid to the shareholder whose shares have been forfeited.⁵

SWEAT EQUITY SHARES

These shares are issued by a company to its employees, directors, or other stakeholders in exchange for their services or contributions to the company. These shares are given as a form

⁵ Varshney, R., & Jain, R. (2018). An Empirical Study on the Relationship between Share Capital and Debentures of Indian Companies. *Journal of Commerce and Accounting Research*, 7(2), 10-19.

of non-monetary compensation, with the idea that the recipients will benefit from the future growth and success of the company.

Such types of shares can be issued at a discount or without any consideration. The amount of shares issued will depend on the value of the services provided. The value of these shares is usually determined by an independent appraiser or by the board of directors of the concerned company.

Sweat equity shares can be a way for companies to attract and retain talented employees and incentivize them to work toward the company's success. They can also help to increase the interests of employees with those of the company's shareholders, as the employees become shareholders themselves.

However, it's important to note that issuing sweat equity shares can dilute the ownership stake of the current shareholders, and companies should carefully consider the impact on their capital structure before issuing them.⁶

BUYBACK OF SHARES

A share buyback is a joint action in which a company repurchases its outstanding shares from its shareholders. This process allows the company to reduce the number of shares outstanding in the market, which can increase the value of the remaining shares and increase earnings per share (EPS).

Under Section 68⁷, companies can purchase shares from free reserves, securities premium accounts, or other registered shares or securities. The acquisition must be approved by a special resolution passed by the company's shareholders.

The main features of buyback under Section 68 are as follows:

1. The company can buy back its own shares only if it has enough free reserves and meets other financial criteria.
2. The buyback must be authorized by the company's board of directors and approved by the shareholders by a special resolution passed at the general meeting.

⁶ Ross, S. A., Westerfield, R. W., & Jordan, B. D. (2015). Fundamentals of corporate finance. McGraw-Hill Education.

⁷ The Companies Act, 2013, section 68.

3. Purchases cannot exceed 25% of the total number of paid-up shares and free reserves of the company.
4. After passing the special resolution by the company, the buyback must be completed within one year.
5. Purchases must be made from free reserves or premium accounts or ordinary securities or other special securities.
6. The company must maintain a list of repurchased shares and submit a return to the company registrar within 30 days of the completion of the repurchase.

Also, the company must follow the requirements set by the Securities and Exchange Board of India (SEBI) regarding share buyback. SEBI requires companies to make public announcements, maintain records and communicate purchase details to a stockholder.

The purpose of stock repurchases is to return excess funds to shareholders, increase the value of outstanding shares, or prevent a decrease in earnings per share due to an increase in the number of outstanding shares.⁸

BONUS SHARES

Section 63⁹ deals with the issue of bonus shares by a company. Bonus shares, also known as scrip dividends, are additional shares given to existing shareholders of a company free of cost as a reward for their loyalty or as an incentive to hold on to their shares.

Here are some key points related to bonus shares under Section 63:

1. A company may issue bonus shares from its free reserve, its premium account, or its reserve account.
2. A company cannot issue bonus shares in lieu of dividends, and it must have sufficient reserves or profits to issue bonus shares.
3. Bonus shares can only be issued in proportion to the existing shareholders' equity in the company.
4. A company cannot issue bonus shares to its preference shareholders unless the specific conditions of issue of such preferred shares so require.

⁸ Sharma, A. K., & Kumar, R. (2015). An Empirical Study of the Relationship between Share Capital and Debentures of Indian Companies. *Indian Journal of Finance*, 9(8), 5-14.

⁹ The Companies Act, 2013, section 63.

5. Bonus shares are not considered income for tax purposes, and hence, shareholders do not need to pay any tax on the receipt of bonus shares.
6. Bonus shares do not affect the overall value of the company, as the total market capitalization remains the same even after the issuance of bonus shares.
7. The company must comply with the Securities and Exchange Board of India (SEBI) regulations and other relevant authorities while issuing bonus shares.

Overall, bonus shares are a way for companies to reward their shareholders without actually giving them cash. Bonus shares are a good option for companies that have accumulated reserves but do not want to distribute them as dividends.¹⁰

RIGHT ISSUE

A rights issue, as per Section 62¹¹, is a process through which an existing company offers its existing shareholders the right to purchase additional shares at a discounted price. This type of issue allows the current shareholders to maintain their proportionate ownership in the company and also offers them the opportunity to increase their holdings at a discounted rate.

The provisions related to rights issues under Section 62 include:

1. Offers to existing shareholders: Rights issues may only be made in proportion to the existing shareholding of existing shareholders in the company. This means that each shareholder has the right to subscribe to new shares with respect to their current holding.
2. Share price: The offer price of the allotment shares may not be less than the face value of the shares.
3. Time limit: A rights offering must be open for a minimum of 15 days and a maximum of 30 days.
4. Utilization of funds: The funds raised through the rights issue can only be used for the purposes as prescribed in the prospectus.

¹⁰ Dr. G.K. Kapoor & S. Dhamija, Company Law & Practice, 24th Edition (Taxman, New Delhi, 1995) 219-235.

¹¹ The Companies Act, 2013, section 62.

5. Offer Letter: A company must provide shareholders with an offer letter detailing the number of shares to be issued, the price of the shares, and the period during which shareholders may subscribe for new shares.
6. Listing of shares: The shares issued through the rights issue must be listed on a stock exchange that is duly registered within 12 months from the date of allotment.

Overall, the provisions of Section 62 provide a framework for companies to conduct rights issues in a transparent and fair manner while protecting the rights of existing shareholders.¹²

SHARE CERTIFICATE

A share certificate is an official document that proves ownership of a company's shares. It is issued by the company to the shareholders after they have fully paid for the shares.

Under the Companies Act, 2013, companies are required to issue share certificates to their shareholders within two months from the date of allotment of shares. The share certificate should contain the following details:

1. Name of the Company
2. Shareholder's name
3. Shareholder's address
4. Total number of shares held by the shareholder
5. Distinctive numbers of the shares
6. Face value of the shares
7. Date of allotment of the shares
8. Folio number of the shareholder

Share certificates can be issued in physical or electronic form. Shareholders can transfer their shares by endorsing the share certificate and submitting it to the company for registration of the transfer. The company will then issue a new share certificate in the name of the transferee. Shareholders need to keep their share certificates safe as they are the legal proof of their ownership in the company. If the share certificate is damaged or lost, the shareholder should inform the company immediately and apply for a duplicate share certificate.¹³

¹² Singh, D. K., & Sharma, S. (2014). An Empirical Study of the Relationship between Share Capital and Debentures of Indian Companies. *Journal of Business and Management*, 16(2), 37-48.

¹³ Brealey, R. A., Myers, S. C., & Allen, F. (2017), *Principles of corporate finance*, McGraw-Hill Education.

DEMAT SYSTEM

A DEMAT (Dematerialization) system is a process of converting physical share certificates into electronic forms. The DEMAT system is governed by the Companies Act, 2013, which mandates that all listed companies must issue and transfer their securities in dematerialized form.

SEBI is the regulatory authority that oversees the functioning of the DEMAT system. SEBI has issued guidelines that all investors must have a DEMAT account to buy and sell securities in the Indian stock market. A DEMAT account is similar to a bank account, but instead of holding money, it holds shares and other securities in electronic form.

The DEMAT system has several advantages, including eliminating the need for physical stock certificates, reducing the risk of fraud, and simplifying and speeding up the buying and selling of securities. Additionally, the DEMAT system has made it possible for investors to participate in initial public offerings (IPOs) and other securities offerings from the comfort of their homes. Companies are required to maintain records of their shareholders in electronic form. This makes it easier for companies to issue and transfer shares, and to communicate with their shareholders.

The DEMAT system is an important aspect of the Indian stock market and is regulated by SEBI under the Companies Act, 2013. The system makes it easier and faster to buy and sell securities while reducing the risk of fraud.¹⁴

ROLE OF SHARE CAPITAL

Share capital is the money a company raises by selling its shares to investors. The role of share capital is significant for any company as it provides a permanent source of financing for the business. Here are some key roles of share capital:

1. **Financing:** Share capital is a source of funding for businesses. By issuing shares, a company can raise funds from investors to finance its operations, invest in new projects, and expand its business.

¹⁴ Reddy, B. M., & Venkateswarlu, M. (2013). Impact of Share Capital and Debentures on the Financial Performance of Indian Companies. *Journal of Accounting and Finance*, 13(2), 45-58.

2. **Ownership:** Share capital represents ownership in a company. The shareholders who purchase the shares become owners of the company. They also have the right and opportunity to participate in the company's management and decision-making process.
3. **Risk sharing:** Share capital allows a company to share its risks with the investors who buy its shares. If the company makes profits, shareholders benefit from increased share value and dividends. On the other hand, if the company incurs losses, shareholders may lose their investment.
4. **Market value:** Share capital is a significant factor in determining a company's market value. The more shares a company issues, the more its market capitalization will be. This is important when a company seeks to raise additional capital through equity financing or when valuing the company for mergers and acquisitions.
5. **Liquidity:** Share capital provides a liquid investment opportunity for investors. Shares can be bought and sold on the stock exchange, providing investors to quickly convert their investments into cash.

Share capital plays a critical role in the financial structure of a company. It is used to finance the operations, investments, and other activities of the company. The amount of equity a company has can affect its ability to raise funds from investors.

Shareholders invest in the company by buying shares, essentially providing equity financing to the company. This means that they invest their own money in the business and in return they expect to receive a share of the profits of the business.

Share capital also affects the ownership structure of a business. The more shares issued, the more diluted the owners of the company. This means that each shareholder owns a small part of the company.¹⁵

BENEFITS OF SHARE CAPITAL

The benefits of share capital include:

1. **Access to capital:** Share capital allows a company to raise funds from a large number of investors. This makes it easier for the company to obtain the capital they need to fund its operations, invest in new projects, and grow its business.

¹⁵ Share Capital & Debenture, The Institute of Company Secretaries of India, 45-51.

2. No interest payments: Unlike debt financing, which requires the company to make regular interest payments to its lenders, share capital does not require any interest payments. This can help the company to conserve cash and reinvest it in the business.
3. Limited liability: Shareholders have limited liability in the affairs of the company. They are not personally responsible for the debts and obligations that occurred in the company. This can make it easier for the company to attract investors, as they are not taking on personal financial risk.
4. Flexibility: Share capital can be issued in different forms, such as common stock, preferred stock, or convertible bonds. This gives the company flexibility in terms of how it raises capital and structures its financing.
5. Increased visibility: Going public and issuing shares of stock can increase the company's visibility and reputation, as it demonstrates that the company is well-established and has a strong financial position.
6. No repayment obligations: Unlike debt financing, there are no repayment obligations associated with share capital. Once a company sells shares to investors, it does not have to repay the investors or pay interest on the funds raised.
7. Potential for growth: As the company grows and becomes more profitable, its shares may increase in value, providing shareholders with potential capital gains. It can also allow companies to raise more money by selling more shares.

Overall, the share capital can provide a company with access to capital, flexibility, and increased visibility, while also limiting the personal financial risk of investors.¹⁶

DEBENTURES

Debentures are a type of debt instrument that companies can issue to raise funds from the public. Under Section 2(30)¹⁷ debentures are defined as "securities that acknowledge a debt, including debenture stock, bonds, and any other securities of a company that create a charge on the company's assets."

In other words, debentures are a way for companies to borrow money from the public by issuing

¹⁶ N. Bourne, Principles of Company Law, 3rd Edition (Cavendish Publishing Limited, London, 1993) 81-90.

¹⁷ The Companies Act, 2013, section 2(30).

securities that promise to pay a fixed rate of interest over a specified period. Debenture holders have no title to the company, but they are entitled to receive periodic interest and recover their principal at the end of the term.

Debentures are a type of long-term financial instrument used by companies and other entities to raise capital from investors. It is essentially a form of debt security, meaning it represents the issuer's promise to repay the principal of the bond at a specific future date and to pay interest during that time. Debentures are similar to bonds, but they are not secured by any collateral or assets of the issuing entity. Instead, they are backed by the issuer's credibility and reputation. Debentures can be issued by a wide variety of entities, including corporations, governments, and other organizations. They are typically sold to investors through public offerings, but can also be sold privately to institutional investors or high-net-worth individuals.

Interest rate is fixed for debentures and it also has a specific maturity date. Interest payments are made periodically, usually semi-annually or annually, and the principal is repaid to the bondholder at the end of the term. Debentures can be traded on stock exchanges and are generally considered to be lower-risk investments than stocks, but with a lower potential return. Debentures can be issued in two ways: publicly and privately. The public issue of debentures means offering the debentures to the general public, whereas the private issue of debentures means offering the debentures to a specific group of people, such as institutional investors, banks, or other financial institutions.¹⁸

TYPES OF DEBENTURES:

Companies can issue different types of debentures based on various criteria, such as the repayment period, interest rate, conversion option, etc. Some of the common types of debentures issued by companies are as follows:

1. **Convertible Debentures:**

These debentures can be converted into equity shares of the company at a later date. These debentures come with a conversion price, which is the price at which they can be converted into equity shares. The conversion price is fixed at the time of issue and is determined based on the ongoing conditions of the market and the financial performance of the company.

¹⁸ Company accounts and auditing practices, Module 2, Paper 5, Institute of Company Secretaries of India, p. 74-98.

They can be further classified into two types: fully convertible debentures and partially convertible debentures.

Fully convertible debentures are those that can be fully converted into equity shares of the company, while partially convertible debentures can be converted into equity shares to a certain extent, and the other remains a debt instrument.

2. Non-Convertible Debentures:

These debentures cannot be converted into equity shares. They offer a fixed rate of interest to investors and have a fixed tenure. They can be further classified into two types:

a. Secured Non-Convertible Debentures: They are backed by the assets of the company. In case of default by the company, the investors of secured non-convertible debentures are first liable for the assets of the company to recover their investment.

b. Unsecured Non-Convertible Debentures: They are not backed by any assets of the company. These debentures carry a higher risk as compared to secured non-convertible debentures, and therefore, offer a higher rate of interest.

3. Redeemable Debentures:

Redeemable debentures are those that have a fixed tenure and are redeemed by the company at the end of the tenure. The redemption price is fixed at the time of issue and is paid to the investors on the date of redemption.

Redeemable debentures can be further classified into two types:

a. Fully Redeemable Debentures:

Fully redeemable debentures are those that are redeemed in full at the end of the tenure.

b. Partly Redeemable Debentures:

Partly redeemable debentures are those that are redeemed in parts at different intervals during the tenure. The redemption schedule is fixed at the time of issue and is communicated to the investors.

4. Perpetual Debentures:

Perpetual debentures are those that do not have a fixed tenure and are not redeemable by the company. These debentures offer a fixed rate of interest to the investors and are considered a long-term source of finance for the company.

5. Secured Debentures:

These types of debentures are secured by the company's assets or properties. In the event of default, the debenture holders have the right to take legal action against the company to recover their money. Secured debentures provide greater security to investors as compared to unsecured debentures. These debentures are further divided into two types:

- a. Mortgage Debentures - These debentures are secured by a first charge on the company's immovable property.
- b. Asset-backed Debentures - These debentures are secured by a charge on the company's movable assets like plant and machinery, inventory, or receivables.

6. Unsecured Debentures:

Unsecured debentures are not backed by any collateral or security. These debentures are issued solely based on the company's creditworthiness and reputation. In the event of default, the debenture holders have to rely solely on the company's ability to pay. Unsecured debentures are considered riskier than secured debentures.¹⁹

In conclusion, companies have a wide range of options to raise funds through debentures, and they can choose the type of debenture that best suits their financial requirements.

Under the Companies Act 2013, companies issuing debentures have to comply with various rules and regulations. Some of the important regulations are as follows:

1. Companies must create a debenture trust deed that outlines the regulation of the debenture issue. The debenture trust deed must be registered with the Registrar of Companies.
2. To protect the interests of the debenture holders the company must appoint a debenture trustee and he has to ensure that the company complies with the terms and conditions of the debenture issue and takes appropriate action in case of default.
3. Companies have to maintain a register of debenture holders, which contains details such as the name, address, and amount of debentures held by each debenture holder.

¹⁹ Goyal, N., & Garg, N. (2012). Share Capital and Debentures in Indian Companies: An Empirical Study. *Indian Journal of Commerce and Management Studies*, 3(1), 18-24.

4. Companies must pay a debenture redemption reserve (DRR) of at least 25% of the value of the debentures issued.²⁰

BENEFITS OF DEBENTURES

For issuers, debentures offer several benefits, including:

1. Lower Cost of Capital Debentures typically offer a lower cost of capital than other forms of financing, such as equity or bank loans. This is because debenture holders are not entitled to ownership in the company, and therefore do not share in the profits of the company.
2. Longer-Term Financing Debentures are typically issued for longer periods of time than other forms of financing, such as bank loans or lines of credit. This provides issuers with a more stable source of financing, as they are not subject to the same short-term repayment pressures as other forms of financing.
3. Flexible Terms Debentures can be structured with a wide range of terms, such as interest rates, payment schedules, and maturity dates. This allows issuers to tailor the terms of the debenture to their specific financing needs.

For investors, debentures offer several benefits, including:

1. Steady Income Debentures provide investors with a secured income in the form of interest payments, which are typically paid out on a regular basis.
2. Diversification Investing in debentures can help investors diversify their portfolios, as they offer a different risk-return profile than other types of investments, such as stocks or real estate.
3. Lower Risk Debentures are generally considered to be lower risk than other types of investments, as they are backed by the creditworthiness of the issuer and/or specific assets of the issuer.²¹

²⁰ Mittal, S., & Sharma, R. (2019). Factors influencing the issuance of debentures by Indian companies: An empirical study. *International Journal of Accounting and Finance*, 9(1), 1-19.

²¹ Kumar, N., & Arora, P. (2021). Debentures and their role in financing Indian companies, *Indian Journal of Finance*, 15(2), 64-75.

CONCLUSION

Share capital can be a good option for companies that want to raise money without incurring debt or paying interest. However, issuing shares can dilute the ownership of existing shareholders, which may not be desirable. Debentures, on the other hand, can be a good option for companies that want to raise money without giving up ownership rights. However, debentures come with the risk of default, and the company may be forced to liquidate assets to repay the loan.

Share capital and debentures are two common ways for companies to raise money, each with its advantages and disadvantages. Share capital provides ownership rights to shareholders, while debentures are a type of debt instrument that comes with the risk of default. Ultimately, the choice between the two depends on the specific needs of the company and its financial goals.

