

UNRAVELING THE AMPHIBIOUS NATURE OF CCDS UNDER IBC



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INTRODUCTION

Compulsorily convertible debentures (“CCDs”), often classified as “deferred equity”, are issued by companies as debentures which are compulsorily convertible into equity upon occurrence of agreed trigger events or post maturity. As a hybrid security, CCDs offer returns by way of interest, while also facilitating ownership in the issuing entity at a later date. Despite falling within the ambit of debentures, CCDs are not redeemable for cash and have been held to not constitute a ‘debenture’ in its classic sense.[1]

This feature of CCDs has also led the Reserve Bank of India to treat CCDs as equity instruments under the foreign direct investments (FDI) guidelines.[2] However, contentions raised in and judgements delivered pursuant to insolvency proceedings under Insolvency and Bankruptcy Code, 2016 (“Code”) have stirred up debate on treatment of CCDs and accompanying rights in the event of the issuer company’s insolvency.

[1] Narendra Kumar Maheshwari v. Union of India, 1990 Supp SCC 440.

[2] Rule 2 (k), Foreign Exchange Management (Non Debt Instruments) Rules, 2019.

CCD AS FINANCIAL DEBT

The meaning and scope of “financial Debt” under the Code^[3] lies at the core of this debate, which definition illustrates various instruments and transactions which are included in the meaning of “financial debt” and includes the following:

“a debt along with interest, if any, which is disbursed against the consideration for the time value of money”; and

“any amount raised pursuant to any note purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument”.

As is evident from the above, while the definition doesn’t expressly refer to CCDs, it includes any amounts raised pursuant to debentures^[4]. In this regard, the National Company Law Tribunal (“NCLT”) and the National Company Law Appellate Tribunal (“NCLAT”) have, through various decisions, held that CCDs, so long as they have not matured or have otherwise not been converted into equity, will fall within the meaning of financial debt and CCD holders would, accordingly, be categorized as “financial creditors”.^[5] However, these decisions have not relied simply on the nomenclature of the instrument. Rather, the decisions of the NCLT and NCLAT were based on an assessment of various facts specific to the cases and, in particular, terms of the CCD which established that the CCDs constituted “disbursement against consideration of time value of money”.^[6] This characteristic underpinned the treatment of such CCDs as “financial debt”.

While the issue of treatment of CCDs as “financial debt” remains open for final determination by the Supreme Court, basis decisions of the tribunals and the provisions of the Code, any argument for such treatment in any proceeding under the Code, would have to meet at least the following requirements:

- CCDs should not have matured/converted at the time of filing of application for initiation of corporate insolvency resolution process (“CIRP”)^[7];
- The date of conversion of CCDs should not be linked to winding up, dissolution or liquidation of the issuer company, or any other analogous event, which could be construed to include the initiation of CIRP^[8];
- The CCD should have provisions for time-based return on money invested (including by way of clear coupon); and
- CCDs should be recorded as a debt / long term borrowing / other financial liabilities under the issuer company’s financial records^[9].

TREATMENT OF PUT OPTIONS

While CCDs are essentially irredeemable, the credit market has evolved structures to enable realisation of the principal amount of CCDs through buyback /put option obligations, particularly in default scenarios. This has also raised questions on treatment of claims arising from the exercise of a put option (independent of the instrument).

[3]Section 5(8) of the Insolvency and Bankruptcy Code, 2016.

[4] Section 5(8)(c) of the Insolvency and Bankruptcy Code, 2016.

[5] Section 5(7) of the Insolvency and Bankruptcy Code, 2016; Srei Multiple Asset Investment Trust v. IDBI Bank Ltd. & Ors., MANU/NL/0066/2022.

[6] Agritrade Power Holding Mauritius Limited and Ors. v. Ashish Arjunkumar Rathi, Interim RP of SKS Power Generation (Chattisgarh) Limited, MANU/NC/2096/2023.

[7] IFCI Limited v. Sutanu Sinha & Ors, MANU/NL/0540/2023.

[8] Agritrade Power Holding Mauritius Limited and Ors. v. Ashish Arjunkumar Rathi, Interim RP of SKS Power Generation (Chattisgarh) Limited, MANU/NC/2096/2023.

[9] SGM Webtech Pvt. Ltd. v. Boulevard Projects Pvt. Ltd., MANU/NC/2636/2020.

In respect of put option relating to debt obligations, the NCLT[10] and the Bombay High Court[11] have held that loan purchase agreements or option agreements, executed in tandem with loan agreements, which entitle a lender to enforce its rights in an event of default, fall within the ambit of a guarantee under the Contract Act, 1872 and therefore, shall be deemed to be financial debt.[12] However, it is important to note that these decisions were given in relation to put options on an underlying loan obligation (and not a CCD or an equity instrument). Therefore, while the aforesaid decision indicates that the obligation arising from a put option facility may be treated as a financial debt, it cannot be read independent of the nature of the underlying /instrument.

In respect of decisions under the Code, the NCLT, in *IL & FS Financial Services Ltd. v. La-Fin Financial Services Pvt. Ltd.*[13], held that a failure by the third party obligor to fulfil the put option obligation in respect of equity shares constitutes financial debt under the Code. In this case, with reference to the definition provided under the Code, the NCLT stated that “financial debt” may be of two types:

Firstly, an amount which is disbursed carrying time value of money; and

Secondly, an amount raised under any other transaction having the commercial effect of a borrowing.

The aforesaid interpretation by the NCLT (which was further affirmed by the NCLAT[14]), was based on the fact

that the definition of financial debt under the Code includes counter indemnity obligations[15] and derivative transactions[16], which do not require any ‘actual disbursement of money’. However, unfortunately, when this matter was subsequently heard by the Supreme Court[17] in appeal, the impugned orders of NCLT and NCLAT were reversed purely on the technical ground that the claim based on the put option was barred by limitation. The Supreme Court, while deciding the matter, did not comment on the merits of the claim. Therefore, while the NCLT and NCLAT decisions provide some support for claiming that the put option even in respect of equity/ equity like instruments falls within the ambit of a financial debt under the Code, this issue again remains open for a final view from the Supreme Court.

Also, to add to the confusion, company law tribunals have set out varying interpretations with respect to the put option right vested with equity shareholders and status of such holders as a “financial creditor”. The NCLT, in *Hubtown Ltd. v. GVFL Trustee Co. (P) Ltd.*[18], drew a distinction between shareholders and lenders, and stated that lenders do not get any voting rights and any contract for acquisition of shareholding in a body corporate can never result in the formation of a debt. Thus, basis the foregoing, NCLT took the view that a put option as an exit right in respect of equity shares cannot be considered as debt.

[10] *Union Bank of India v. Era Infra Engineering*, CA No. 997(PB)/2018 in CP No. IB-190(PB)/2017.

[11] *Vandana Global Limited v. IL&FS Financial Services Limited*, 2018 SCC OnLine Bom 337.

[12] Section 5(8)(i), Insolvency and Bankruptcy Code, 2016.

[13] 2018 SCC OnLine NCLT 11437.

[14] *Pushpa Shah v. I.L. & F.S. Financial Services Ltd.*, 2019 SCC OnLine NCLAT 1543

[15] Section 5(8) (h) of the Insolvency and Bankruptcy Code, 2016.

[16] Section 5(8)(g) of the Insolvency and Bankruptcy Code, 2016.

[17] *Jignesh Shah v. Union of India*, (2019) 10 SCC 750.

[18] 2021 SCC OnLine NCLT 3103.

CONCLUSION

In conclusion, while some recent decisions seem to indicate that CCD holders are likely to be treated as financial creditors, the judicial position on this is far from settled. In any event, investments in CCDs cannot be treated as having the same degree of protection under law as is available to optionally convertible or non-convertible debentures. While investors may seek to mitigate their investment risks by building contractual terms which indicate the intent of the parties to treat this as “financial debt” in specific situations, it is prudent to do so with the understanding that there is a non-zero risk that CCDs may be treated as equity or similar to equity in any insolvency proceedings.

Authors:



Shivi Rastogi,
Managing Partner
E: shivi@amicusservices.in



Abhilasha Bhatia
Associate

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