Meaning of a Debenture

In corporate finance, a debenture is a medium- to long-term debt instrument used by large companies to borrow money, at a fixed rate of interest. The legal term "debenture" originally referred to a document that either creates a debt or acknowledges it, but in some countries the term is now used interchangeably with bond, loan stock or note. A debenture is thus like a certificate of loan or a loan bond evidencing the fact that the company is liable to pay a specified amount with interest. Although the money raised by the debentures becomes a part of the company's capital structure, it does not become share capital.

Features of a Debenture:

1. A debenture-holder is a creditor of a company.

2. It is a document, issued by companies, acknowledges a debt.

3. It is a movable property.

4. Each debenture is numbered.

5. Usually a debenture creates floating charge over the assets of the company.

6. A debenture-holder has no right to vote in companies meetings.

7. . A debenture –holder is entitled to fixed rate of interest

Classes of Debentures:

Debentures may be classified into different types on the basis of different terms and conditions of issue.

They are given below:

(A) On the Basis of Transferability:

They are of two types:

(1) Bearer or Unregistered Debenture:

These are debentures which are payable to bearer and are transferable by mere delivery. The company does not maintain any register of holders of these debentures. The interest due is paid to the holder irrespective of his identity on the production of interest coupons attached to the debentures. This type of debentures are treated as negotiable instruments.

(2) Registered Debenture:

These debentures are registered in the books of the Company. In other words, a registered holder is one whose name, address etc. appears both on the Debenture Certificate and the Company's Register of Debentures, as required to be maintained under Sec. 152. Transfer can be effected only by fulfilling the legal formalities in accordance with the provisions of Sec. 108 of the Companies Act. Registered debentures are not negotiable instruments.

(B) On the Basis of Security:

They are of two types:

(1) Simple or Naked or Unsecured Debenture:

These are debentures which are not secured by any charge or mortgage on the assets of the company. The holders of such debentures are not given any security as to the payment of interest and repayment of capital. A holder of an unsecured debenture is merely an ordinary creditor. The solvency of the Company is the only security for the holders of simple debentures.

(2) Mortgage or Secured Debentures:

These are debentures which are secured by a charge or mortgage on the assets of the Company. Again the charge may be fixed or floating charge. If particular assets like Land, Buildings etc. are charged or mortgaged as a security, then it is known as fixed charge.

Where the charge is not fixed on any particular asset, but is overall assets of the Company, it is called floating charge. Thus, the debenture holder has a right to recover his principal amount as well as unpaid interest out of the assets mortgaged by the Company.

(C) On the Basis of Redeemability:

They are of two types:

(i) Redeemable Debentures:

Debentures are usually issued on the condition that they shall be redeemed after a certain period. Such Debentures are known as Redeemable Debentures. They may be re-issued after redemption in accordance with the provision of Sec. 121.

(2) Irredeemable or Perpetual Debentures:

These are Debentures which are not ordinarily repayable within the life time of the Company. The question of repayment arises only in the case of either liquidation of the Company or when a Company makes a default in the payment of interest.

(D) On the Basis of Convertibility:

They are of two types:

(1) Convertible Debentures:

These are debentures issued with an understanding that the holders of such debentures are given option to exchange their debentures for shares at any time, as per the terms of the Company

(2) Non-Convertible Debentures:

The debenture not convertible into shares of the Company is termed as non-convertible debenture.

(E) On the Basis of Priority:

They are of two types:

(1) First Mortgage Debentures:

These debentures are those that have a first claim over other debentures as regards the payment of the property mortgaged.

(2) Second Mortgage Debentures:

These debentures are payable after the redemption of the first mortgage debentures.