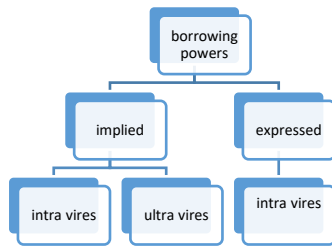


DEBT CAPITAL



Borrowing powers of a company

- To entitle a company to borrow, it must have power to borrow given to it by its constitution.
- All companies have an implied power to borrow for purposes incidental to their trade or business.

TYPES OF BORROWING

1. Express borrowing

Arises where the power to borrow is specifically mentioned in the company's constitution I.e. AOA

2. Implied borrowing

A company has implied power to borrow if it is undertaking a commercial activity, trade or business

Further borrowing by a company can fall into two categories.

1. Intra vires borrowing

This is when the borrowing has been authorised by the company constitution and all the procedure in respect to such borrowing have been properly complied with.

2. Ultra vires borrowing

This occurs when borrowing transaction is totally beyond the powers of the company i.e. it is not provided within the company's constitution or where irregularities have occurred under such borrowing. It is simply an abuse of powers by directors. Ultra vires borrowing can be categorized into the following:

a) **Ultra vires borrowing to both the company and directors**

In this case, neither the amount nor the purpose of borrowing is authorised by the company's constitution. The transaction is therefore null and void and as such, the lender cannot legally sue the company to recover the money lent. He may however seek equitable remedies such as injunction, tracing and identification.

Such borrowing cannot be ratified (approved) by the company since it is null and void.

b) **Ultra vires borrowing to directors but intra vires to the company.**

In this case the amount and the purpose of borrowing is authorised by the company's constitution but the directors have adopted a wrong procedure in exercising the borrowing powers e.g. failure to convene a board meeting in order to pass a resolution to such borrowing.

This can be ratified in order to have a company assume the responsibility of borrowing the payment of such debts towards the lenders.

Remedies for lenders against the company in case of ultra vires borrowing.

If lender has acted in good faith. i.e. without the knowledge that the company borrowed the money beyond its powers, he may have the following remedies:

1. **Injunction**: - if the company has not spent the money borrowed, the lender may obtain an injunction order against the company restraining from spending the amount and recover the same.
2. **Subrogation**: - if the money has been applied in paying off debts of the company, the lender is entitled to step into the shoes of the creditors so paid off and rank as creditor of the company to the extent of the money so applied. If the money has been invested in some particular assets, he may claim the assets
3. **Sue for breach of warranty**:- lenders may sue the directors personally for breach of the implied warranty of authority and claim damages for the same
4. **Identification and tracing**: -If the lender can identify his money where the money is still in the hands of the company in its original form or any property purchased with it, he can claim the money or property purchased with it.

Effects of Ultra vires Borrowing (Dec 2010 Q3)

- a) A borrowing is ultra vires if a company borrows beyond the powers as stipulated in the memorandum of association.
- b) In such case, no debt is created against the company.
- c) Any security given is inoperative.
- d) The contract is void and cannot be ratified
- e) The lender cannot sue the company for the repayment of the loan. He can only obtain injunction, seek subrogation, seek tracing order or sue directors for breach of warranty.

Debentures

- A debenture is the written acknowledgement of a debt by a company normally containing provisions as to payment of interest and terms of repayment of principal.

Debenture stock

Debenture stock is a group of fully paid up debenture put together into a large mass, generally secured by a trust deed.

Distinction between debenture and debenture stock

DEBENTURE	DEBENTURE STOCK
<ul style="list-style-type: none">• Group of fully paid up debenture	<ul style="list-style-type: none">• Unit of debt capital
<ul style="list-style-type: none">• May be issued with/ without security	<ul style="list-style-type: none">• It is generally created by a trust deed

<ul style="list-style-type: none"> • They are identified by a distinct number 	<ul style="list-style-type: none"> • They do not have such distinct number
<ul style="list-style-type: none"> • Debenture need not fully paid 	<ul style="list-style-type: none"> • They must be fully paid.
<ul style="list-style-type: none"> • A debenture is transferred for a fixed sum 	<ul style="list-style-type: none"> • Debenture stock can be transferred to fractional amounts

Distinction between shares and debentures (MAY 2019 2bii)

SHARES	DEBENTURES
A shareholder is a member of a company whose name must be in the register of members.	Debenture holder is a creditor of the company whose name must be on the register of debenture holder.
A company cannot purchase its own shares.	A company can purchase its own debenture.
Dividends are paid to shareholders out of profits.	Interest on debenture is paid out of profits but if not available may be paid out of capital.
Shares are usually not issued at a discount.	Debentures may be issued at a discount.
Shares are not secured.	Debenture are generally secured.
Shareholders repayment of capital is postponed until all the debenture holders are paid in full.	Debenture holders must be paid before anything is distributed to shareholders in liquidation.
A share is a unit of a member's investment in a company measured in terms of money.	Debentures is a unit of loan capital must be paid to the lenders in accordance to the terms of debenture document.
Shares are generally irredeemable.	Debentures are generally redeemable.

Similarities between shares and debentures

- A debenture is usually one of a series, which is similar to a class of share.
- Both shares and debentures are long term investments transferable in same manner.
- Both shares and debentures can be issued in the same way i.e. through prospectus.
- Sale of both shares and debentures bring money to the company.
- Both shares and debentures create a debt to a company.

Types of debentures

Classification according to negotiability.

1. Registered and bearer debentures

Registered debentures are registered with the company in the name of the holder.

Transfer is effected by delivering proper instrument of transfer to a company.

Bearer debentures are made payable to the bearer. They are transferable by mere delivery and therefore are negotiable instruments.

Classification according to security

2. Secured and unsecured debentures

Secured debenture is one that grants a mortgage or charge over a company property therefore a holder has an advantage over other ordinary creditors. Unsecured debentures have no charge on the assets of the company.

Classification according to permanence

3. Perpetual and redeemable debentures

Perpetual debenture is one that has no repayment date or which is expressed to be repayable only when a company is winding up.

Redeemable debenture stipulates that repayment shall be made on or before fixed date.

Redeemable debentures may be issued unless the AOA provides to the contrary or the company has shown an intention to cancel them by passing a resolution to that effect.

Classification according to conversion

4. Convertible and inconvertible debentures,

The holder of convertible debentures is given an option to convert the debenture into an ordinary or preference shares at a given rate of exchange i.e. to enable holders acquire equity capital.

Conditions for conversion

- i. There must be an authority in the AOA
- ii. An ordinary resolution must be passed.
- iii. They are first offered to the existing debenture holders and the employees shareholder.

Inconvertible debentures on the other hand retain their Status until they are redeemed by company.

Classification according to priority.

5, Single and series debenture

Single debenture is one issued to creditor covering one debt. **Series debenture** is a debenture covering several debts.

Advantages of debentures

- i. Debenture is easily traded
- ii. Its terms are clear and specific so that a company can be certain of its true position.
- iii. Debentures secured by floating charges are popular instruments, they give the holders a security of a charge but the assets charged can be freely traded by a company.
- iv. They offer to potential investors the security of guaranteed income.
- v. They are more popular than preference shares,

- vi. Their requirements are more relaxed in the company's Act e.g. There is no restriction by the company to buy them.

Disadvantages of debentures

- i. A Company may have to offer a relatively high rate of interest in order to make the debentures attractive.
- ii. Payment of debenture interest is mandatory and not discretionary.
- iii. Interest payment results in a reduction of dividends payable to shareholders and cause a fall in share prices
- iv. Debenture holders remedies include 'appointment of receivers, which may have disastrous consequences on the company,
- v. Crystallization of a floating charge means that the same security is swiftly enforced since that security will often be of a trading assets and its enforcement can cause major problems for the company,

Characteristics of debentures

- i. It is usually in the form of a certificate showing acknowledgement of indebtedness
- ii. it is an instrument in writing
- iii. It is under the company's seal
- iv. It is one of a series issued to a number of lenders although we also have single debentures
- v. It usually specifies specific period or date when payment is to be made.
- vi. It generally creates a charge on the company's asset
- vii. A holder is not a member of the company and has no right to vote in the companies' meeting

Contents of Debenture Certificate

- Name of the company
- Name of the debenture holder
- Number of debentures held
- Nominal value of debentures
- Interest rates
- Extent to which they are paid
- Common seal of the company
- Signature of the directors

TRUST DEED

When debentures are offered for public subscriptions, the company usually enters into a trust deed with trustees. The trustees are appointed and paid by the company to act on behalf of the debenture holders. The charge securing the debentures is 'made in favor of the trustees who hold it in trust. Under the deed the company undertakes to pay to the debenture holders their principle and interest and normally charges its property to the trustees as security.

Provisions of the trust deed (June 2011,Q3b)

- a) Appointment and remuneration of trustees
- b) Type of debentures e.g. bearer /registered etc.

- c) Creation of a charge
- d) Enforcement of the charge
- e) Methods of enforcing a charge
- f) The obligations of the company e.g. to insure the property
- g) The powers of the trustees e.g. to appoint receivers
- h) Priority of debentures
- i) Convening of meeting of debenture holders by trustees so as to take instruction.
- j) A covenant or promise by the company to pay the debt.
- k) A description of the property charged.
- l) A provision empowering the trustees to take possession of the property charged in the event the security becoming enforceable and to carry on the company's business and even to sell the property charged.

Advantages of trust deed (Nov 2015 Q5b (i) May 2017 Q4 (I))

- i. The trustees have a legal mortgage over the company's property. It enables the security by way of a specific mortgage/ charge on the company's land. The creation of a legal charge gives a legal interest to the person in favor of whom it is drawn
- ii. It facilitates protection of security on behalf of all creditors. The interest of debenture holders are safe guarded more efficiently by a small group of trustees.
- iii. The trustees are often empowered to call meeting and inform the debenture holders of the position and receive Instructions.
- iv. The trustees act quickly if there is default in terms of the debentures: e.g. appoint receivers, sell the secured property etc.
- v. Obligations can be imposed on, the company which otherwise can be impracticable e.g. to insure and repair the premises. The trustees are in a position to see that the company carries out these obligations.
- vi. The, deed carries the circumstances with which the principal sum may become repayable.
- vii. The appointment of trustees facilitates efficient administration of the trust since they are there and exercise continuous supervision of the debenture holder's right's and to take prompt action if need arises (act as a watchdog)
- viii. If there is to be a specific mortgage/ charge in shares in a subsidiary company, trustees are needed in order that someone independent on the holding company can exercise any right to vote.

Liability of trustees

A trustee is liable for any breach of trust where he fails to show the of care and diligence required of him as trustees, having regard to the provisions of the trust deed conferring him any powers, authorities or discretions. In particular, they cannot purchase the debentures without, the consent of all debenture holders,

Any provision in a trust deed or in a contract with the holders of debentures secured by a trust deed exempting a trustee from, or indemnifying him against, liability for breach of trust where he fails to show the degree of care and diligence required of him as trustee shall be void (companies Act 2015)

Exception to above rule

A trustee will not be liable in the following cases;

- a) Where the trustee can show that he took such care and diligence as is required of him as trustee having regard to the powers, authorities and discretion conferred on him by the trust deed.
- b) Where a majority than 3/4 in value of the debenture holders present and voting in person, or where proxies are permitted at a meeting summoned for the purpose, agree and voting relates to specific acts or omissions or to a trustee who is dead or has ceased to act.
- c) If such a person being a director or other officer of the company in the opinion of the court has acted honestly and reasonably, he can be relieved from liability in respect of negligence, default, breach of duty or trust.

Register of debenture holders.

Companies Act provide that, every company which issues a series of debenture is required to keep at its registered office a register of holders of such debentures.

If the work of making up the register is done at some other office of the company or of another person, it may be kept at that office.

A company shall register an allotment of debenture as soon as is practicable and in any event within 2 months after the date of allotment.

The Registrar shall be notified of such place and of any change thereof.

Particulars of the register of debenture holders/ charges (DEC 2014, Q7C)

- a) The name, address, occupation of each debenture holders
- b) The debenture held by each holder distinguishing each debenture by its number
- c) The amount paid or agreed, to be paid on the debenture
- d) The date at which each person was entered in the register as a debenture holder
- e) The date at which any person ceased to be a debenture holder.

Every company to keep at its registered office a register of charges with the following particulars

- a) A short description of the property charged
- b) The amount of charge

Remedies/Rights to debenture holders in the event of default by the company.

((JUNE 2011,Q3B MAY 2017, Q7A)

In the event of company's default either in the repayment of interest or principal sum, the debenture holders as creditors may exercise the following:-

- i. Appoint a receiver to carry on the business of the company
- ii. Petition the High court for compulsory winding up on the ground of inability to pay debts.
- iii. Sue the company for arrears of interest, principal sum or both
- iv. Apply for an order of closure. i.e. the effect of an order for closure is to extinguish the company's equitable right of redemption and vest the property to the creditors absolutely.

CHARGES

A charge is an encumbrance upon real or personal property granting the holder certain rights over that property.

A charge secured over a company's assets gives to the creditor (called the chargee) a prior claim (over other creditors) to payment of their debt out of those assets.

It is a right to the lender to sell the property charged or otherwise the case may be,

Types of charges

a. Legal charge

A legal charge or mortgage is created, when the assets charged are transferred by the company to the lender subject to the company's equitable right of redemption.

b. Equitable Charge

An equitable charge or mortgage is created when the company deposits a document of title to the property to the lender to hold it until the mortgage debt is redeemed. Here, the lender does not acquire any title to the property.

c. Fixed Charge

Is a charge mortgaged on a specific property such as a plant and machinery, land and buildings or uncalled capital. A fixed charge passes legal title to certain specific assets and the company loses the right to dispose the said property.

Advantages of a fixed charge

- It is a mortgage of specific property e.g. value of the security is known
- It prevents the company from disposing off the property secured by the charge without the consent of the holders of the charge.
- The lender has absolute priority.
- The holder of fixed charge has a valid security and has powers over other debentures either to appoint a receiver or sell the security property.
- The chargee is in a position to control usage of security. This enables him prevent its wastage.

d. Floating charge

This is an equitable charge securing a debenture on the assets of a going concern. The company gives to the charge rights over its assets while retaining freedom to deal with them in the ordinary course of business until it crystallizes.

Characteristics of a floating charge

- It is an equitable charge
- Does not fasten on any definite asset until the date of crystallization
- During the currency of the loan, the content of the security is always changing as the company is free to dispose off the assets within the charge and acquire new assets that will become the subject matter of the charge.
- The process is usually continuous unless and until the charge crystallizes i.e. becomes attached to the assets of the class charged at the moment of crystallization or which comes into existence thereafter.

NOTE:

While a floating charge is floating, 'it is a dormant security because the charge does not attach or fix at the time its creation upon any particular asset.

Advantages of floating charges

- i. All classes of assets can be used.
- ii. The company has an implied license to deal freely with the assets charged until crystallization

- iii. The class of assets charged will be used in the ordinary course of business and will be changing from time to time
- iv. The debenture holder has sufficient security in form of assets i.e. if the company defaults, he has power to appoint a receiver or sell the security proposed.
- v. The debenture holder has guaranteed income i.e. interest on debentures payable from undistributed profits and if not from capital.
- vi. It enables companies without fixed assets to borrow because it is only created on current assets.
- vii. It enhances the company's borrowing powers.
- viii. It enables the company to charge property, which would otherwise not be charged since such a property, cannot be a subject of a fixed charge.

Disadvantages of floating charge

- I. The content of the security fluctuates and therefore the value is uncertain until it crystallizes
- II. The company has the freedom to deal with its assets before the charge crystallizes.
- III. The rights of the holders are postponed to other interest
- IV. The charge may be avoided if it is not registered within 42 days from the date of its creation.
- V. If created within 6 months before the commencement of winding up, it is deemed to be a fraudulent preference and it is void.
- VI. It is subordinate to a fixed charge.
- VII. A floating charge will not crystallize on certain grounds
- VIII. The charge is avoided during liquidation unless it is proved that the company was solvent at the time the charge was created.

Crystallization of floating charge (Sept 2015,Q5A, MAY 2017,Q4A ii)

A floating charge is said to crystallize when it becomes fixed or fastened on the assets charged. A floating charge will crystallize on the following grounds:-

- 1. On the liquidation or the winding up of the company.
- 2. If a receiver is appointed to take over the company's assets.
- 3. If execution of a court decree against the company's assets is issued.
- 4. If another floating charge crystallizes within the company's structure which causes the company to cease carrying on business.
- 5. When there is a default in paying the principle and interest.
- 6. When certain events set out in the trust deed occur e.g. when the property is in danger.

Priority of charges (NOV 2016,Q4B)

Sometimes a combination of legal and equitable charges or fixed and floating charges are created in the same assets. It is necessary in such cases to ascertain how these charges would rank in the event of company's liquidation. The following rules apply in ranking of charges:-

- 1. **Where a series of fixed charges are created on the same assets, they shall rank on the basis of the date of creation** unless there is an express agreement among the lenders that 'they shall rank "pari passu" i.e. they rank irrespective of their dates of creation.
- 2. **Where a series of fixed charges and floating charges are created on the same assets, the fixed charges shall have priority to all floating charges** Irrespective of the dates of creation. However, an earlier floating charge shall take priority to a later fixed charge if:
 - (a) The floating charge contains a "negative pledge clause" which prohibits the company from later on creating a fixed charge with priority over it

- (b) The holder of the subsequent fixed charge actually knew of the prohibition.
3. **If two floating charges are created over the general assets of the company, they rank in order of creation** since the equities are equal and first in time must prevail.
 4. **If a company creates a floating charge over a particular kind of assets e.g. book debts, the charge shall rank before an existing floating charge over the general assets.**
 5. **A registered charge takes priority over unregistered charge.**

The following have priority over a floating charge:

- a) A later fixed charge
- b) An execution creditor i.e. one who completes execution before crystallization.
- c) A landlord's distress for rent levy before crystallization of floating charge.
- d) Any right of lien arising before crystallization.
- e) A creditor who obtains from the court "a garnishee order" attaching any goods/ money which a third party or which belongs to the creditor so that it can be used to pay off the creditor.
- f) A supplier of goods to the company who has included a retention clause in their invoice.
- g) Negative pledge clause- A creditor to whom a floating charge is given may seek to protect himself against losing his priority by including in the terms of a floating charge a "negative pledge clause" which prevents the company against creating a subsequent fixed charge over the same property which otherwise takes priority.
- h) Rates, taxes and wages.

Avoidance of charges

A fixed charge/ floating charge is void and the holder treated as unsecured creditors if

- (i) The charge is not registered within 42 days from the date of its creation.
- (ii) If the creation of the charge was a fraudulent preference

Registration of charges

The law provides that every company must keep a copy of every instrument creating a charge required to be registered at the registered office of the company. These copies and register of charges must be open for inspection by any creditors or member of the company during business hours. Companies Act provides that the prescribed particulars of the following charges created by the company together with the instruments creating them must be delivered to the Registrar within 30 days after creation.

Charges to be registered (MAY 2016, Q6A)

- i. Charges securing an issue of debentures
- ii. Charges on uncalled share capital
- iii. A charge requiring registration under the Chattels Transfer Act e.g. letter of hypothecation.
- iv. A charge on any land or interest in land
- v. A charge of book debts of the company
- vi. A charge on calls made but not paid
- vii. A floating charge on the undertaking / property of the company
- viii. A charge on a ship or share in a ship

- ix. A charge on goodwill, licenses, patents, trademarks or copyright

Particulars to be registered

- i. Total amount secured by the charge
- ii. The date of the resolution authorizing the issue of the series and the date of recovery of the deed.
- iii. A general description of the identity of the charge
- iv. The names, postal addresses and description of the trustees
- v. The amount or the rate of commission, allowance or discount
- vi. Particulars of the company

The purpose of registering the aforesaid particulars is to enable the would be creditors to know the company existing indebtedness and the assets available for their settlement. Certificate of registration of charges is issued upon registration of charges.

Effects of non-registration (NOV 2017, Q7A)

Failure to register a registrable charge within the prescribed period shall attract the following consequences: -

- i. The sums lent shall become payable immediately i.e. the lender can demand the balance of the loan immediately even if the borrower is complying with other terms of the agreement e.g. paying instalments on due dates.
- ii. The charge shall be void as against a subsequent lender/ the liquidator i.e. the charge shall be unsecured creditor and if the company were to charge the same property to subsequent lender shall have a supreme claim to that asset.
- iii. Similarly, if the company goes into liquidator, the liquidation shall have a superior claim over the creditor whose charge was not registered.